IN THE

Supreme Court of the United States

OCTOBER TERM, 1962

No. 476

BENJAMIN BRAUNSTEIN and DIANA BRAUNSTEIN; Estate of Benjamin Neisloss, Deceased, JULIA NEISLOSS and RUSSELL NEISLOSS, Executors, and JULIA NEISLOSS; HARRY NEISLOSS and LILLIAN NEISLOSS, *Petitioners*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR PETITIONERS

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BRIEF FOR PETITIONERS

OPINIONS BELOW

The opinion of the Tax Court, the trial judge dissenting (A. 184-281),[1] is reported in 36 T.C. 22 (1961). The opinion of the Court of Appeals (R. 21-39) is reported in 305 F. 2d 949.

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[1] "A" refers to the record filed in this Court on the petition for certiorari. It is stipulated that either of the parties may refer to portions of that record.

JURISDICTION

The judgments of the Court of Appeals were entered on July 6, 1962. (R. 39-41.) The petition for a writ of certiorari was filed on October 1, 1962, and granted on December 10, 1962. (R. 42.) The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

QUESTION PRESENTED

Section 117(m) of the Internal Revenue Code of 1939 provides that gain from the sale or exchange of stock in a collapsible corporation is taxable as ordinary income rather than capital gain. The question presented is whether the section applies where the stockholders would have been entitled to capital gain treatment if they had conducted the enterprise in their individual capacities.

STATUTES INVOLVED

The pertinent statutes appear in the Appendix, *infra*, pp. 1a-4a.*

STATEMENT

Benjamin Braunstein and Diana Braunstein, and Harry Neisloss and Lillian Neisloss are, respectively, husband and wife. (R. 16.) Benjamin Neisloss and Julia Neisloss were husband and wife before his death on February 4, 1960. (R. 16, 22.) Each couple filed a joint income tax return for the calendar year 1950. (R. 16.) The husbands are hereinafter referred to as the petitioners.

Benjamin and Harry Neisloss were brothers. (R. 17.) From 1919 on they were engaged in holding and managing investments in real estate. (R. 17.) Benjamin Braunstein is an architect who became associated with them about 1930. (R. 17.)

In the 1920's the Neislosses acquired and improved commercial properties, and purchased parcels of land for development. The various holdings were owned and managed through corporations. (R. 5-7, 17.) In the 1930's the Neislosses organized a corporation which built and operated commercial properties, and another which built and operated a garden-type apartment development. They held their stock in these ventures for about 10 and 15 years, respectively. (R. 7, 9, 17.) In 1938 the Neislosses and Braunstein constructed a large apartment house through a corporation. The corporation sold the property in 1941 and was dissolved. (R. 17.) The profit on the sale was reported as a corporate gain. (R. 9.)

Between 1943 and 1948 the petitioners organized five corporations which constructed multiple dwelling projects financed under section 608 of the National Housing Act. (R. 17.) The petitioners were equal stockholders in each corporation. (R. 17.) All five projects consisted of garden-type apartments. (R. 11-12, 17.) The projects and their dates of completion were as follows (R. 2, 18):

Projects	Dates of Completion
Somerset Homes, Inc.	March 1, 1943
Somerville Gardens, Inc.	September 1, 1943
Madison Gardens, Inc.	February 1, 1944
Monroe Gardens, Inc.	November 1, 1945
Brookside Gardens, Inc.	January 1, 1948

On November 30, 1949, the petitioners sold their stock in Monroe Gardens because they received a very good offer. (R. 2, 12, 18.) They had not been looking for a purchaser. The sale was solicited by a broker on behalf of the buyer. (R. 13, 18.) The petitioners

reported their profit on the sale as a capital gain, and the Commissioner did not question this treatment. (R. 13-18.) Throughout 1950 the petitioners continued to own their stock in the other four FHA projects completed in 1943, 1944, and early 1948. (R. 18.)

This case involves another FHA rental development known as Oakland Gardens. On March 31, 1948, the petitioners organized two corporations to build and operate Oakland Gardens. The corporations were Springfield Development Co., Inc. and Hill Development Co., Inc., hereinafter referred to as Springfield and Hill. (R. 26.) Two corporations were formed, rather than one, because section 608(b)(3) of the National Housing Act, 12 U.S.C. § 1743(b)(3) (1952), barred loans beyond $5 million to any one mortgagor. (R. 22.) The insured loans to the two corporations totalled $6,101,600. (R. 26.) Each petitioner owned one-third of the common stock in both corporations. (R. 26.) The petitioners' shares were not stock in trade or property of a kind includible in inventory. Nor did the petitioners hold their shares for sale to customers in the ordinary course of trade or business. (R. 19.) The FHA acquired 100 shares of preferred stock in each corporation pursuant to its rules and regulations. (R. 26.)

Construction started in April, 1948, and the buildings were completed between September, 1948, and June, 1949. (R. 26.) The eventual costs of construction were less than the FHA had estimated. (R. 26-27.) The mortgage loans of $6,101,600 exceeded the costs by $159,757.75. (R. 1-2, 27.)

Both the petitioners and the FHA made careful financial analyses of the development before it was built. (R. 28.) These studies indicated that the de-

velopment would be self-liquidating, *i.e.*, that the revenues would be sufficient to amortize the mortgage loans and pay interest, while providing a satisfactory return. The FHA estimated that the annual return after debt servicing would be about $78,000. The petitioners counted on a return of $45,000. (R. 28.)

The estimates of the petitioners and the FHA were based on assumed vacancies of 7% for apartments and garages. (R. 31.) However, between January and May, 1950, the vacancy rate was high, resulting in a rental loss of $16,000 on an annual basis. The development was also unexpectedly burdened by expenses of about $10,000 for removing garbage and rubbish, and another $10,000 for increased costs of redecorating. In addition, the development faced a rise of $30,000 in real estate taxes, and a further cost of $31,000 for free utilities to tenants in order to compete with neighboring projects. (R. 29-31.)

In the latter part of May, 1950, the petitioners were approached by brokers on behalf of two prospective purchasers. (R. 32.) On June 8, 1950, the petitioners entered into an agreement to sell their stock in Springfield and Hill. (R. 32.) The closing was scheduled for not later than September 30th. (R. 18.) At the insistence of the buyers, who did not want to pay for the cash held by the corporations, Springfield and Hill distributed $550,000 to the petitioners. The distributions were made as part of the sale transaction. (R. 22, 32; A. 244.) Neither corporation had any accumulated earnings or profits at the time of the distributions, or any earnings or profits for its taxable year in which the distributions were made. (R. 32-33.)

The sale was not completed in September because one of the buyers refused to go through with the pur-

chase. (R. 18.) After still further delays by the buyers, the sale was consummated on November 13, 1950. (R. 19, 32.) The sales price, as finally adjusted, was $399,702. (R. 33.) The two corporations continued to own the development and provided utilities free to their tenants. (R. 18.)

The petitioners remained active in the operation of rental properties held as long-term investments. They continued to hold their stock in four other FHA projects completed in 1943, 1944, and early 1948. See p. 3, *supra*. The stock in all four was sold in May, 1953, in one transaction. The sale was solicited by brokers acting on behalf of the buyers. (R. 12, 18.) In 1952 the petitioners, in their individual capacities, built a shopping center which they still owned at the time of trial in 1957. (R. 15, 19.) In 1955 they organized a corporation which built a large apartment house. The corporation still owned the building at the time of trial. (R. 15.) In 1956 they remodeled apartments and built stores on property which they had held for about ten years. (R. 15, 19.)

Each petitioner reported his gain attributable to the sale as long-term capital gain. (R. 33.) The Commissioner determined that the gains were taxable as ordinary income on the ground that Springfield and Hill were collapsible corporations within section 117(m) of the 1939 Code. The Tax Court sustained his determination. Judge Kern, the trial judge, dissented. (R. 23-24.) The Court of Appeals affirmed the decision of the Tax Court. (R. 21-39.)

The petitioners argued in the Court of Appeals that the corporations were not collapsible because they were not used as a means of converting ordinary income into

capital gain. The petitioners further contended that the corporations were not collapsible because the project was not built with a view to a quick sale. In this connection they asserted that the sale was unexpectedly due to the loss of rental income, and increased costs and taxes.[2] The Court of Appeals resolved both issues against the petitioners. In regard to the first, the court held that the corporations were collapsible even though the petitioners would have realized capital gains if they had owned the property individually. In regard to the second, the court agreed with the petitioners that in May, 1950, the vacancies were excessive and the vacancy rate was high. (R. 31.) Nor did it dispute the increased taxes, and the additional costs of redecorating, garbage and rubbish removal, and free utilities to tenants. (R. 29-31.) However, the court concluded that the sale was not due to these adverse developments, but had been previously contemplated during construction. This determination rested essentially on the ground that the admitted loss from vacancies and the heavier costs of redecorating could not be considered cumulatively with the additional burden of providing free utilities. (R. 31.). See further Pet. for Writ of Cert., pp. 11-18.

This Court granted the petition for certiorari, limited to a review of the question whether section 117(m) applies "in circumstances where the stockholders would have been entitled to capital-gains treatment had they conducted the enterprise in their individual capacities

[2] The petitioners also argued that even if the corporations were collapsible, the profit realized by them was not taxable as ordinary income because less than 70 percent of the profit was gain attributable to the constructed property. See Int. Rev. Code of 1939, § 117(m)(3).

without utilizing a corporation." (R. 42.) The Fifth Circuit has resolved the same question in favor of the taxpayer, in an opinion written by Judge Wisdom and concurred in by Judges Rives and Cameron. *United States* v. *Ivey*, 294 F. 2d 799 (1961), *rehearing denied*, 303 F. 2d 109 (1962).[3]

SUMMARY OF ARGUMENT

The gains realized by the petitioners through the sale are taxable as long-term capital gains unless section 117(m) applies. Section 117(m) provides that gain from the sale or exchange of stock in a collapsible corporation is taxable as ordinary income. A collapsible corporation is defined as a corporation formed or used principally for constructing property with a view to the shareholders' realization of "gain attributable to such property" before the corporation realizes a substantial part of the net income to be derived from the property. The "gain attributable to such property," within the meaning of the statute, is profit which constitutes a conversion of ordinary income into capital gain through the use of the corporation. Springfield and Hill were not collapsible corporations because there was no such conversion here. As the court below recognized, the profit realized here would have been capital gain if the petitioners had individually owned and operated the development.

Section 117(m) is a subsidiary statute in a comprehensive legislative scheme dealing with the treatment of capital gains and losses. That scheme provides the framework within which section 117(m) appropriately applies. The basic provisions on capital gains are sub-

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[3] Judge Cameron dissented in favor of the taxpayer with respect to another issue in the case.

sections (a) and (c) of section 117, as amplified by subsection (j) of the same section. Under these provisions long-term capital gains are taxed at a lower rate than other income. A long-term capital gain is a gain realized on a sale or exchange of "property" held for over 6 months, including real property and depreciable property used in a trade or business—excluding stock in trade, property includible in inventory, and property held primarily for sale to customers in the ordinary course of trade or business. The purpose of these interrelated provisions is to relieve taxpayers from excessive tax burdens on the conversion of capital investments or the realization of capital appreciation, and to remove the deterrent effects of any such burdens. Over the years the Court has closely construed the provisions in response to this controlling purpose. Hence the Court has consistently refused to apply them to a gain which is essentially profit from the everyday operation of a business or a substitute for what would otherwise be received as ordinary income. In short, a taxpayer cannot convert ordinary income into capital gain under cover of a sale or exchange of "property".

Section 117(m) is a further evolution of the same basic principle, and is to be construed accordingly. Like the decisions of this Court, it is solely concerned with attempts to convert ordinary income into capital gain.

I.

The meaning of "gain attributable to such property" is fully revealed by the legislative history of section 117(m). This legislative history consists of a tax message by the President, testimony by the Secretary

of the Treasury and the General Counsel of the Treasury in hearings before the Ways and Means Committee, a Joint Memorandum prepared by the Treasury and the Staff of the Joint Committee on Internal Revenue Taxation, reports of the Ways and Means Committee and the Finance Committee, and an additional Summary by the Staff of the Joint Committee. As this illuminating history shows, "gain attributable to such property" is profit which would otherwise constitute ordinary income if the corporation had realized it in the ordinary course of business or if the enterprise had been individually owned and operated.

By the same token, Springfield and Hill were not collapsible corporations. For they were not used as a means of realizing the gain contemplated by the statute. The development was property used in a trade or business. If the corporations had directly sold the development, the profit would have been a capital gain. If the petitioners had directly owned and sold the development, the profit would also have been a capital gain. The sale of the stock instead of the assets simply produced a similar capital gain. At the same time the corporations continued to realize the ordinary income from the property as ordinary income. Since the gain was not a disguised realization of ordinary income from the constructed property, it was not "gain attributable to such property" within the meaning of section 117(m).

The decision below has perverted section 117(m) by converting capital gain into ordinary income. The statute has been turned into a penal levy. Taxpayers who have not engaged in any tax avoidance are punished for having held property through a corporation rather than as individuals.

II.

The Court of Appeals rejected our interpretation of the statute on the ground that it was contrary to the "literal" meaning of the statute. The court's resort to "literalism" consists of two errors—quite apart from the absurdity of the result. First, the court gratuitously assumed that gain attributable to the constructed property, as contemplated by the statute, "literally" means only what the court thought it meant. Second, even if this "literal" assumption were correct, the court egregiously erred in ignoring the plain-spoken purpose and policy of section 117(m).

The Court of Appeals' reliance on the "literal" meaning is merely obvious question-begging. It simply assumes what it supposedly seeks to establish—that the words in question necessarily have only one meaning, regardless of their particular context or purpose. As this Court has repeatedly held, in regard to tax statutes as well as other statutes, the meaning of words is shaped by the setting in which they are used. The same word or phrase has diverse meanings in diverse contexts. The content given to words should accordingly conform to the sense in which they are used. This settled principle of construction is all the more significant where the application of a statute turns on such a protean concept as gain. Hence, no matter how "clear" a statute may seem on a hasty reading or superficial examination, nothing precludes the use of legislative materials in aid of its construction.

The question here is not what the words in issue may mean as an abstract matter. The question is what they mean as concretely used in section 117(m). And that meaning is unmistakably disclosed in the authoritative

pronouncements made in the hearings and the committee reports. There is no question of doing violence to the "literal" language of the statute. For here we are considering a flexible phrase whose connotation depends on the context in which it appears. The Court of Appeals read the words involved in isolation from their special setting. The net result is that it reached an apparently senseless conclusion. Under the decision below a statute designed to prevent the conversion of ordinary income into capital gain has just the opposite effect of converting capital gain into ordinary income.

The correct answer is the same even if the phrase "gain attributable to such property" means "literally" what the Court of Appeals imputed to it. This Court has definitively disapproved a dogma of "literal" interpretation which confines itself to the bare words of a statute. To construe a statute is to ascertain its meaning, and that meaning is to be determined in the light of its history and purpose. Therefore, regardless of how "plain" the words may be, the Court will not read them so as to produce absurd, harsh, or incongruous results. Even when the bare words do not entail an absurd result, but an unreasonable one at variance with the policy of the legislation as a whole, the Court refuses to sacrifice common sense. Whenever possible, a statute should be given a sensible construction, consistent with the legislative purpose.

This principle is repeatedly applied in taxation—particularly in regard to section 117(a). Various gains have been denied capital gain treatment in accordance with legislative history and policy, though the statutory language, abstractly considered, is broad enough to encompass such gains. What is true of section 117

(a) is necessarily just as true of section 117(m). For subsection (m) is merely a policing provision designed to safeguard the policy expressed in subsection (a). The common purpose of both is to maintain a line between profits from the everyday operation of a business and profits from appreciation accrued over a period of time. Since subsection (a) makes no attempt to tax profits from appreciation as ordinary income, no purpose to do so can be attributed to subsection (m). The Government itself has refused to construe subsection (m) in "literal" fashion, where the result would have extended the statute beyond its intended purpose.

If section 117(m) is applied here on the pretext of "literalness", the result will be harsh and incongruous, as well as plainly absurd. It will squarely contradict the result clearly contemplated by Congress. Instead of preventing the conversion of ordinary income into capital gain, the Commissioner will harshly penalize the petitioners by converting capital gain into ordinary income. They will be severely punished merely because they owned the property through corporations rather than as individuals. The court below expressly conceded that its "literal" reading of the statute "produces unwarranted taxation of capital gains as ordinary income." (R. 36.) Or, as the Fifth Circuit concluded in *United States v. Ivey, supra,* at 803, the Commissioner's construction "would make nonsense of the statute." Neither the hearings nor the reports reveal the slightest desire to enact such novel legislation which would tax, as ordinary income, profits that are normally realized as capital gains.

III.

Our position is cogently confirmed by the scheme and structure of section 117(m). The phrase "gain attributable to such property" does not stand alone, but gathers meaning from the words around it.

A corporation is collapsible only if it is formed or used principally for construction "with a view to" the shareholders' realization of the gain attributable to the property. The required "view" and the gain are interrelated elements of one over-all rule of law created by the statute. The phrase "with a view to" predicates liability on a particular purpose—the purpose to obtain the gain proscribed by the statute. A corporation is collapsible, then, only if used for construction as a calculated means of realizing that benefit. The pronounced emphasis on purpose or motive is designed to make sure that the statute is closely confined to corporations that are intentionally used to secure that gain. Therefore, that gain must be some special advantage not obtainable in normal fashion by the corporation itself or by the shareholders as direct owners of the enterprise. And that advantage or gain can only be profit that constitutes an attempted conversion of ordinary income into capital gain. Otherwise the emphasis on purpose or motive makes little sense. For the statute is then read as saying that a corporation is collapsible if it is calculatedly used as a means of realizing a capital gain which is otherwise normally realized as a capital gain.

Another part of the statute—clause (i) of section 117(m)(2)(A)—is equally revealing. Under that clause a corporation, if it is to be deemed collapsible, must be formed or used for construction with a view

to a sale or exchange of its stock before the corporation itself realizes "a substantial part of the net income to be derived from the property." This "net income" is the normal profit to be derived from the property in the ordinary course of the business. The statute is applied in relation to the amount of such "net income" in order to compel the corporate realization of substantial profit taxable at ordinary rates. But this concern with ordinary income at the corporate level is pointless unless the gain proscribed at the stockholder level constitutes such ordinary income converted into capital gain.

Still another portion of the statute sheds further light in support of our conclusion. Paragraph (1) of section 117(m) provides that gain realized on a sale of stock in a collapsible corporation is taxable as ordinary income. The gain is treated as ordinary income in order to compensate for the fact that the same gain would normally be realized and taxed as ordinary income. Therefore, once more it necessarily follows—if the statute is to be sensibly read—that the gain attributable to the property is gain which constitutes a conversion of ordinary business profit.

All these additional considerations converge to the same conclusion that Springfield and Hill were not collapsible corporations.

IV.

Apart from its "literal" construction, the Court of Appeals sought to sustain the deficiencies on the further ground that section 117(m) was meant to apply to "some cases when the asset if sold by the taxpayer would have produced capital gain." (R. 37.) How-

ever, these are all cases where ordinary income, consisting of rents, is converted into capital gain through a liquidation of a corporation. The court erroneously reasoned that if the statute may apply to a profit realized in the case of a liquidation, then it necessarily applies to a profit realized in the case of a sale of stock. As the Court of Appeals read the statute, it is wholly immaterial that the profits from the sale and from the liquidation are distinctly different in kind.

In order to reach every kind of converted ordinary income, the draftsmen of the statute covered both liquidations of corporations and sales of stock. The one and only purpose was to prevent conversions in each and every case, regardless of which method was used. But it does not in the least follow, as the court below inferred, that because the statute may apply to a liquidation relating to property held for rental, it *ipso facto* applies to a sale of stock. The relevant inquiry is not whether a sale should be treated like a liquidation, but whether a stockholder is enabled to realize the gain proscribed by the statute—the gain that Congress intended to tax as disguised ordinary income. Our conclusion in this respect is confirmed by the committee reports. Whether the profit is realized through a liquidation or a sale of stock, the application of section 117 (m) turns on the nature or content of the profit—just as it does when section 117(a) is involved. The fact that a liquidation may produce the precise gain contemplated by Congress is no reason for penalizing a sale which, by the Court of Appeals' own admission, has not produced any such gain.

In the end the Court of Appeals falls back once more on its "literal" reading of the statute. At the same time it rather frankly concedes that it has not in-

terpreted the words of section 117(m) "in light of their purposes in order to carry out Congressional intent." (R. 38-39.) The Court of Appeals attempts to justify the mutilation of legislative policy by citing this Court's opinion in *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962). However, the Court of Appeals has clearly misconstrued the *Hanover Bank* decision—which reversed the same Court of Appeals.

V.

As a final ground for its conclusion, the Court of Appeals refers to a statute enacted eight years after the taxable year involved here. This later statute is section 341(e) of the 1954 Code, an amendment added by section 20 of the Technical Changes Act of 1958. The Court of Appeals has seriously misconstrued this later action of Congress—even if, for the moment, it is deemed otherwise relevant here. The 1958 amendment and its legislative history confirm that the Treasury has harshly misapplied section 117(m). Moreover, the court's attempted reliance on the 1958 amendment directly contravenes the amendment itself and its authoritative committee report. Even if the amendment, on some theory, were possibly relevant as a retroactive gloss on section 341 of the 1954 Code, it cannot affect section 117(m) of the 1939 Code.

In any event—quite apart from the special considerations involved here—the 1958 amendment and the related committee report cannot cast any retroactive implications in the Commissioner's favor. Later legislative history is not relevant evidence of what a prior statute means. The obligations of a taxpayer for a particular year stem from the statutes passed by Congress for that year. Nothing that was said in 1958 can

change the legislative purpose and policy expressed in 1950. The Commissioner's position is no better insofar as the amendment itself is concerned. A later statute sheds no light on what an earlier Congress contemplated or intended. It cannot give a statute enacted earlier a different meaning from what it then acquired.

VI.

The Commissioner's position in this case raises a basic issue which goes to the very essence of tax administration in our democratic society. May the Treasury disregard legislative hearings and committee reports which clearly disclose the intended meaning and scope of tax legislation entrusted to its fair administration? May it close its eyes and ears to the plainly expressed policy of a statute and proceed to improvise a policy of its own? These questions involve no less than the integrity of the administrative process in our tax system. This case unhappily reveals the kind of administration which raises such questions. For we have here a steadfast refusal to pay attention to an unmistakable legislative purpose—a purpose to which the Treasury itself significantly contributed. It would, indeed, be a sad reflection on our tax system and the Treasury if taxpayers could not rely on a unanimous expression of views voiced by the President, the Secretary of the Treasury, the General Counsel of the Treasury, the House Ways and Means Committee, the Senate Finance Committee, and the Staff of the Joint Committee on Internal Revenue Taxation. The position now taken by the Government is completely at odds with all these official statements on the statute.

Published hearings and reports are meant to be read and studied by taxpayers and their advisers. Today they are well-nigh indispensable as an important source of reasonable expectations. They are a significant means of providing a fair measure of certainty to which taxpayers are surely entitled. If the Treasury may disregard relevant hearings and reports, then they are essentially delusive snares laid for taxpayers and their advisers. The Treasury would ignore not only the message of the President and the reports of both tax committees, but also its own repeated assurances on the precise reach of the statute—assurances given by the head of the Treasury and another high-ranking official. It was on the basis of these repeated assurances, given after full consideration of the evils involved, that Congress acted. The Treasury should not be allowed to slight committee reports and its considered assurances before tax committees. In these days of high rates, it is all the more urgent that the Treasury be obliged to abide by its professions and assurances. At the very least a fair and objective execution of the tax laws requires the Government to keep faith with Congress and those to whom Congress has addressed its laws.

Here the Treasury's change of position does not even have the excuse of improving the statute. Whatever the differences between the Second and Fifth Circuits, they both agree on one thing—that the tax asserted here produces an unreasonable result. The Second Circuit calls it "unwarranted"; the Fifth Circuit, "nonsense."

ARGUMENT

THE GAINS REALIZED BY THE PETITIONERS ARE NOT TAXABLE AS ORDINARY INCOME UNDER SECTION 117(m) OF THE INTERNAL REVENUE CODE OF 1939

The gains realized by the petitioners through the sale are taxable as long-term capital gains unless section 117(m) applies. Int. Rev. Code of 1939, §§ 115(d), 117(a)-(c). Section 117(m) was enacted in 1950. Revenue Act of 1950, § 212(a). It is a special statute directed against certain schemes in tax avoidance—the use of so-called collapsible corporations. The statute consists of three paragraphs. The first prescribes the tax treatment of gain realized by a stockholder in a collapsible corporation. The second defines the special nature of a collapsible corporation. The third limits the application of section 117(m) though the corporation is otherwise collapsible. For present purposes we are primarily concerned with paragraphs (1) and (2).

Paragraph (1) generally provides that gain "from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation" is taxable as ordinary income if, in the absence of section 117(m), the gain would qualify as a long-term capital gain. Paragraph (2) defines a collapsible corporation as:

> "a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—
>
> "(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from the property, and

"(ii) the realization by such shareholders of gain attributable to such property."[4]

A collapsible corporation, then, is a very special kind of entity. It is a corporation which was formed or used principally for construction with a view to achieving two results. One intended result is "the sale or exchange of stock by its shareholders" or "a distribution to its shareholders" before the corporation realizes "a substantial part of the net income to be derived from" the constructed property. The other intended result is "the realization" by the shareholders of "gain attributable to such property." A corporation is not collapsible unless both requirements are met.

The question before the Court turns on the meaning of the second requirement. We contend that Springfield and Hill were not collapsible corporations because the development was not built as a means of having the shareholders realize, within the meaning of the statute, "gain attributable to such property." In our view, "gain attributable to such property" is profit which constitutes a conversion of ordinary income into capital gain through the use of the corporation. In other words, the second requirement is not met where the profit would have been capital gain if the stockholders had held the property directly rather than through a corporation. As the court below recognized, the profit realized here would have been capital gain if the petitioners had individually owned and operated the development. See further pp. 68-69, *infra*.

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[4] We are quoting the statute as it stood in 1950—the year before the Court. In 1951 the definition was expanded to include corporations acquiring certain properties through purchase. Revenue Act of 1951, § 326.

Section 117(m) is a subsidiary statute in a comprehensive legislative scheme dealing with the treatment of capital gains and losses. Therefore, that scheme necessarily provides the framework for our analysis. For "the meaning of a statute is to be looked for, not in any single section, but in all the parts together and in their relation to the end in view." Cardozo, J., in *Panama Refining Co.* v. *Ryan*, 293 U.S. 388, 439 (1935). See also *Jarecki* v. *Searle & Co.*, 367 U.S. 303, 307-308 (1961); *Richards* v. *United States*, 369 U.S. 1, 11 (1962).

The tax structure of capital gains and losses rests essentially on section 117(a) and (c). Subsection (c) provides that long-term capital gains are subject to a lesser tax than other income. Moreover, the tax on such gains is limited to 25 percent of the gains. Subsection (a) defines a long-term capital gain as "gain from the sale or exchange of a capital asset held for more than 6 months." The term "capital assets" is, in turn, defined as "property held by the taxpayer (whether or not connected with his trade or business)" —subject to various exclusions. Among these exclusions are stock in trade, property includible in inventory, property held primarily for sale to customers in the ordinary course of trade or business, and depreciable property and real property used in a trade or business. The definition of "capital assets" is significantly amplified by section 117(j), which states that gain realized on a sale or exchange of "property used in the trade or business" is taxable as gain from a sale or exchange of capital assets held for more than 6 months. The term "property used in the trade or business" means depreciable property and real property used in a trade or business, "held for more than 6

months"—excluding, once more, stock in trade, property includible in inventory, and property held primarily for sale to customers in the ordinary course of trade or business.

The purpose of these interrelated provisions is "to relieve" taxpayers from "excessive tax burdens on gains resulting from a conversion of capital investments, and to remove the deterrent effect of those burdens on such conversions." *Burnet* v. *Harmel*, 287 U.S. 103, 106 (1932). Hence over the years the Court has closely construed the provisions in response to this controlling purpose. As the Court recently stated, "While a capital asset is defined in § 117(a)(1) as 'property held by the taxpayer,' it is evident that not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset. This Court has long held that the term 'capital asset' is to be construed narrowly in accordance with the purpose of Congress to afford capital-gains treatment only in situations typically involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year." *Commissioner* v. *Gillette Motor Transport*, 364 U.S. 130, 134 (1960).

The Court formulated this basic principle of construction at the very outset, and has consistently applied it ever since. In *Burnet* v. *Harmel*, *supra*, it held that a lessor's receipts under oil and gas leases are taxable as ordinary income, though operations under such leases entail the transfer of ownership from the lessor to the lessee. After carefully reviewing the relevant legislative history and policy, the Court concluded that the treatment of the receipts as ordinary income "does

not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act." Profits from oil and gas operations are essentially the same as profits regularly realized in a manufacturing enterprise. Their taxation as ordinary income "does not act as a deterrent upon conversion of capital assets." 287 U.S. at 106.

The later decisions of the Court have equally implemented the purpose underlying the capital gain statutes. A lump sum received by a lessor, as consideration for cancelling a lease, is taxable as ordinary income. *Hort* v. *Commissioner*, 313 U.S. 28 (1941). Even though a lease is "property" for various purposes, a payment for its termination is "not a return of capital." The payment is "merely a substitute for the rent reserved in the lease." A cancellation of a lease involves "nothing more than relinquishment of the right to future rental payments in return for a present substitute payment and possession of the leased premises." *Id.* at 31-32. Similarly, transactions in corn futures, integrally related to the taxpayer's manufacturing business, are not sales of capital assets. *Corn Products Co.* v. *Commissioner*, 350 U.S. 46 (1956). "Admittedly," the Court stated, such futures do not "come within the literal language of the exclusions set out" in section 117(a). Nevertheless they are not capital assets, because the statute "must not be so broadly applied as to defeat rather than further the purpose of Congress." *Id.* at 51-52. "Congress intended that profits and losses arising from the everyday operation of a business be considered as ordinary income or loss rather than capital gain or loss. The preferential treatment provided by § 117 applies to transactions in property which are not the normal source of business income." *Id.* at 52.

More recently the Court held that an amount received on a sale of an oil payment right is not a capital gain, though the right is an interest in land. *Commissioner v. Lake*, 356 U.S. 260 (1958). "We do not see here," the Court stated, "any conversion of a capital investment. The lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income." "The substance of what was assigned was the right to receive future income. The substance of what was received was the present value of income which the recipient would otherwise obtain in the future. In short, consideration was paid for the right to receive future income, not for an increase in the value of the income-producing property." *Id.* at 265-266. The same conclusion was reached where the Government compensated a motor carrier for a temporary taking of its facilities. *Commissioner v. Gillette Motor Transport, supra.* The payment was recompense for use, "which is commonly regarded as rent." The right appropriated was "only the right to determine the use to which those facilities were to be put." It makes no difference that such a right is concededly "property" in the ordinary sense. The right to use is "manifestly not of the type which gave rise to the hardship of the realization in one year of an advance in value over cost built up in several years, which is what Congress sought to ameliorate by the capital-gains provisions." 364 U.S. 130, 134-136 (1960).

All these decisions are variations on the same basic theme. The special treatment of capital gains in section 117 applies only to "gains resulting from a conversion of capital investments," or "an increase in the value of the income-producing property." It does not

apply to profits from "the everyday operation of a business"; transactions which are "the normal source of business income"; or "a substitute for what would otherwise be received at a future time as ordinary income." In short, a taxpayer cannot convert ordinary income into capital gain under cover of a sale or exchange of "property". The taxpayer is simply converting future income into present income.

Section 117(m) is a further variation on the same significant theme. Like the decisions of this Court, it is concerned with attempts to convert ordinary business profit into capital gain. It is a policing provision designed to cope, in a certain area, with the perennial problem which this Court has resolved on a case-by-case basis under section 117, as illuminated by its history and purpose. To borrow the words of Mr. Justice Cardozo, the successive revenue acts reflect the Government's repeated efforts to thwart taxpayers who would escape from a large tax on ordinary income to a smaller tax on capital gains. See, *e.g.*, Int. Rev. Code of 1939, §§ 115(g), 117(l), (o). "At times escape has been blocked by the resources of the judicial process." Section 117(m) is another chapter in the same recurring endeavor to prevent the conversion of ordinary income into capital gain. Cf. *Burnet* v. *Wells*, 289 U.S. 673, 675-677 (1933).[5]

[5] Cf. *Massey Motors* v. *United States*, 364 U.S. 92, 97 (1960), involving efforts to convert ordinary income into capital gain through depreciation deductions. And see further Int. Rev. Code of 1954, § 1245, added by Revenue Act of 1962, § 13(a), 76 Stat. 1032.

I. The Corporations Were Not Collapsible Because They Were Not Used as a Means of Realizing a Gain Constituting a Conversion of Ordinary Income Into Capital Gain

We now turn to the precise particulars of the present dispute. As we have indicated, the controversy turns on the meaning of the phrase "gain attributable to such property," as used in section 117(m). The meaning of these words is scarcely obscure. Before the statute was enacted, Congress and the Treasury amply disclosed what they had in mind. Unlike other disputes over tax statutes (cf. *United States* v. *Benedict*, 338 U.S. 692 (1950)), we are "dealing here with a situation where the meaning of statutory language is resolved by reference to explicit statements of Congressional purpose." *Helvering* v. *Reynolds*, 313 U.S. 428, 431-432 (1941). See also *Colony, Inc.* v. *Commissioner*, 357 U.S. 28, 33 (1958); *Commissioner* v. *Bilder*, 369 U.S. 489, 502 (1962).

Section 117(m) derived from a recommendation made by the Treasury to Congress. On January 23, 1950, President Truman sent Congress a message proposing that it close various loopholes "to improve the fairness of the tax system." He specifically requested corrective legislation for certain "inequities." "Most of these," he emphasized, "permit individuals, by one device or another, to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains. As one example, under present law producers of motion pictures, and their star players, have attempted to avoid taxes by creating temporary corporations which are dissolved after making one film. By this device, their income from making the film, which ought to be taxed at the individual-income tax rates, would be taxed only at

the capital-gains rate. Thus, they might escape as much as two-thirds of the tax they should pay." *Hearings before the Committee on Ways and Means on Revenue Revision of 1950*, 81st Cong., 2d Sess. 2-5 (1950).

The President's message was followed by hearings before the Ways and Means Committee. The Committee approved his proposal to foreclose "this device", after extensive testimony by Treasury Secretary John W. Snyder and Treasury General Counsel Thomas J. Lynch. Their thoughtful analysis in aid of Congress sheds particularly cogent light on the purpose and scope of the statute.

Secretary Snyder referred to a list of "tax loopholes together with proposed remedies" which had been "developed jointly by the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation." The list was contained in a Joint Memorandum submitted to the Committee. "A number of these loopholes," the Secretary stated, "arise out of defects in the capital gains tax structure, which provides a maximum effective rate of 25 percent on gains from capital assets held for more than 6 months. The President, in his recent tax message to the Congress, gave an example of one of these loopholes, the 'collapsible' corporation, through which individuals, engaged in the business of producing certain types of property, have attempted to convert ordinary business and earned income into long-term capital gains." *Id.* at 20.

The Joint Memorandum reiterated the Administration's concern over "the loophole through which individuals, engaged in the production of certain types

of property, have attempted to convert their ordinary business income into the more favorably treated capital gains by means of corporate shells." The Memorandum then elaborated on this problem of conversion as follows:

"For example, if a motion-picture producer made all of his pictures as an individual, his entire gain from such operations would be taxed at individual rates which range as high as 82 percent. If he produced all of such films through a single corporation, the corporation would pay a tax of as high as 38 percent on the profits as realized, and the producer would pay an individual income tax as such profits are distributed by the corporation. Producers have tried to avoid these results by organizing separate corporations for each motion picture; upon completion of the film but prior to the realization of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the estimated value of the released production will be amortized against the income from the film as it is received. If the income from the film does not exceed its estimated value, there is no further tax. . . ." *Id.* at 70.

"Thus," the Memorandum pointed out, "the producer's profit from the picture, which would ordinarily be taxable first at the corporate rate and then at the individual income tax rate when received as dividends, has borne only a single 25-percent tax." The Memo-

randum then noted that this conversion of ordinary income into capital gain was not confined to the motion-picture industry:

"It is undersood that the tax-saving device of organizing and liquidating a corporation for the purpose of securing similar tax benefits is also being used to some extent in the building and construction trades. Individuals engaged in the building or construction business organize a corporation for each development project, not only for the purpose of limiting liabilities, but for the purpose of securing these benefits. The corporation is organized at the beginning of construction and is liquidated upon completion of the project and before any sales are made. If the corporation continued in existence and sold all the units itself, it would pay an ordinary income tax on the difference between the amount received for the units and the cost of construction.

"In order to secure tax benefits, the corporation is permitted to exist only until the construction is completed or for 6 months after its stock was issued, whichever date is the later, and upon liquidation the value of the units distributed is estimated at the amount for which it is expected the units will be sold. On this basis, the stockholders report as a long-term capital gain the difference between the net amount they expect to receive and the cost of the stock owned by them at the time of the liquidation. Having received the assets, the stockholders proceed to sell the assets and to report for tax purposes as an ordinary gain or loss the difference between the value at which the assets were acquired on the liquidation and the actual selling price." *Id.* at 70.

The Memorandum concluded: "It is recommended . . . that long-term capital-gains treatment be denied to any shareholder who sells or liquidates his securities in any corporation so utilized by him for such tax avoidance purposes." *Id.* at 71.[6]

General Counsel Lynch dwelt further on the precise problem which disturbed the Treasury—"the so-called collapsible corporations by means of which individual taxpayers seek to convert ordinary business income into long-term capital gains." And he reiterated the Treasury's desire to foreclose capital-gains treatment "to any shareholder who sells or liquidates his securities in any corporation so utilized by him for such tax-avoidance purposes." As in the Joint Memorandum, he specifically referred to builders who seek to convert into capital gain what would be ordinary income if the corporation sold the property itself. *Id.* at 137-138.

"In considering the remedy" for collapsible corporations, Mr. Lynch continued, it must be recognized "that most corporate enterprises are organized to do business and are designed to operate for profit. We do not propose any change in the present treatment applicable to the liquidation of such corporations." However, "where it appears that a corporation was organized or acquired by an individual or group of individuals to manufacture or produce property without any intention to operate the corporation in the

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[6] See also *Hearings before the Committee on Finance on H.R. 8920*, 81st Cong., 2d Sess. 9 (1950), in which Secretary Snyder emphasized anew the Treasury's concern with "devices, such as the collapsible corporation," which "allow taxpayers unintended access to the more favorable rates of tax levied on long-term gains by permitting conversion of short-term gains or ordinary income into long-term gains."

normal manner or without a view toward realization of profits by such corporation, it is recommended that such shareholders be denied the favorable long-term capital-gains treatment which might now be applicable with respect to the sale or liquidation of their stock." *Id.* at 139.

A colloquy then occurred between Representative Mills, of the Committee, and Mr. Lynch. Representative Mills stated:

> "Mr. Lynch, let me see if I understand this problem. An individual will establish a corporation for the purpose of holding the assets, something he has created, some property that he created, such as a motion picture. When that purpose is served and he feels that the corporation is no longer needed, the corporation is liquidated and the assets will be in turn transferred to him or the others who own stock in the corporation.
>
> "During the time the corporation is in existence, no corporation income tax is paid, because no income is realized. When the assets are transferred from the corporation to the stockholders, the difference between the basis for the stock and the value of the assets is treated as capital gains rather than ordinary income for income-tax purposes, and thus the rate of tax is 25 percent."

Mr. Mills asked whether "that" was what the Treasury desired to have "corrected."

Mr. Lynch answered:

> "That is right. It is the fact that these corporations are designed specifically to receive no income, and the procedure is such that they receive no income. The purpose for which they are created to produce a product for trade, to produce a motion picture, that process is ordinarily truncated

at the point where there would be some income to the corporation so as to avoid the corporation tax." *Ibid.*

Mr. Lynch went on to indicate that this procedure enabled the stockholders to substitute a capital gains tax for the ordinary tax that the corporation would usually pay on business profits if the picture were released by the corporation in normal fashion. Mr. Mills then asked: "Do I understand now that it is the Treasury's suggestion that we legislate in such a way that the Treasury may have the opportunity of reviewing these situations, and if it appears that the device is used to evade tax payment, the Treasury may, instead of assessing the capital-gains rate, assess the regular income-tax rate on the individual?" Mr. Lynch replied, "That is right. The effect of it would be to view the corporation device as a mere sham, organized not for the purpose of carrying on business, but only for the particular purpose of carrying out what we would characterize as tax avoidance." *Id.* at 139-140.

Representative Jenkins, of the Committee, explored the Treasury's proposal in regard to the construction industry. "Suppose," he inquired, "there is a real-estate man, a plasterer and a lumberman and an electrician, a plumber and 2 or 3 more, say 10, who engaged in some construction work. Suppose they go to work and build a big addition. They buy the land cheap and they do the work economically and well. In other words, it is a money-making proposition. The 10 of them build 100 houses. If it is so simple as this, after they have done the work can they dissolve and apportion those homes out 10 to each one?" Mr. Lynch indicated that the case put by Mr. Jenkins was

"the type of device" with which the Treasury was concerned. *Id.* at 140-141.

Toward the end of his testimony Mr. Lynch stated that the Treasury opposed any corrective legislation which would endow it with "great discretion." The Treasury desired a "specific" statute, with "definite standards." It also wished "to be assured that the legislation" would "not place in jeopardy the normal liquidation of corporations, corporations which are organized and carried on regularly to conduct a business." Mr. Mills declared, "It should be clearly understood, then, that there is no purpose on the part of the Treasury to jeopardize the liquidation of corporations." Mr. Lynch answered, "Not those that are carried on in the traditional and regular way." In response to another question, he said, "We want the law to define what this is and not to leave it to the discretion of the Commissioner." *Id.* at 140-141.

The reports of the tax committees further delineate the design and scope of section 117(m). "The collapsible corporation," they state, "is a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 percent." They specifically note that "the term 'collapsible corporation' is so defined as to include corporations lending themselves" to this "attempted tax-saving practice." The reports focus initially on the movie industry in summarizing the evil at which the statute strikes. "A legitimate corporation engaged in the business of producing motion pictures would pay ordinarily the corporate income tax on its net income and its shareholders would pay ordinary income tax on their dividends from the corpora-

tion. Producers have tried to avoid these results by organizing separate corporations for each motion picture. Upon completion of the film but prior to the realization by the corporation of any income therefrom, the corporation is liquidated and the assets are distributed. In such a case, the corporation pays no tax, claiming that it has realized no income. The producer pays tax upon the difference between his cost and the fair market value of the assets so distributed; but such gain is reported as long-term capital gain with a maximum effective rate of 25 percent. After liquidation, the fair market value of the released production is ordinarily amortized against the income from the film as it is received. If the income from the film does not exceed such fair market value, there is no further tax." The same "device," the reports add, "has also been used in the building-construction trade by contractors who have corporations construct buildings for sale and then liquidate the corporations and sell the buildings as individuals." Finally, the reports state that section 117(m) applies to sales of stock as well as liquidations. "While the primary use made of collapsible corporations in the past has usually involved their liquidation in the manner" described, stockholders using "such a corporation could raise the same tax questions" through a sale of stock "at the time and under the circumstances when the corporation might otherwise be liquidated." H.R. Rep. No. 2319, 81st Cong., 2d Sess. 56-57, 97 (1950); Sen. Rep. No. 2375, 81st Cong., 2d Sess. 45, 89 (1950). See also Summary of H.R. 8920, "The Revenue Act of 1950," As Agreed to by the Conferees, Prepared by the Staff of the Joint Committee on Internal Revenue Taxation 17 (Sept. 1950).

In the light of the committee reports and the Treasury testimony, the meaning of "gain attributable to such property" readily emerges. The statute defines a collapsible corporation as a corporation used for construction with a view to the shareholders' realization of gain attributable to the constructed property before the corporation itself realizes a substantial part of the net income to be derived from the property. As the legislative history plainly shows, the "gain attributable to such property" is profit which would otherwise constitute ordinary income if the corporation had realized it in the ordinary course of business or if the enterprise had been individually owned and operated.

We fail to see how any other meaning can be imputed to the gain in question, unless the plain-spoken legislative history is to be completely ignored. The collapsible corporation is repeatedly described as "a device"—something which is deliberately contrived to achieve a certain result. That result is repeatedly condemned as an "inequity" and a "loophole". And the nature of the inequity and loophole is unmistakably identified. A collapsible corporation is a "device" designed "to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains"; a means whereby income "which ought to be taxed at the individual-income tax rates" is "taxed only at the capital-gains rate"; a "loophole" whereby individuals "have attempted to convert their ordinary business income into the more favorably treated capital gains"; a corporation enabling taxpayers to avoid paying either the ordinary individual rates or the regular corporate rate "on the profits" of their business operations; a "tax-saving device" used "for the purpose of securing"

such benefits; a "corporation so utilized" by a shareholder "for such tax avoidance purposes"; a "device" which allows "taxpayers unintended access to the more favorable rates of tax levied on long-term gains by permitting conversion of short-term gains or ordinary income into long-term gains"; a "means" whereby "individual taxpayers seek to convert ordinary business income into long-term capital gain"; a corporation organized "without a view toward realization of profits by such corporation" and designed "to avoid the corporation tax"; a corporation used to avoid "the corporate income tax" on net income and "ordinary income tax" on individual income; "a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at a rate of 25 percent"; and "corporations lending themselves" to this "attempted tax-saving practice." See pp. 27-35, *supra*.

The legislative history of section 117(m) speaks for itself. The statute is directed solely against a specific tax abuse. It is narrowly concerned with corporations which are deliberately used to construct or produce property in order to obtain a special benefit or gain for stockholders through a liquidation or sale of stock. And that benefit or gain consists of having the usual profit earned on the property taxed as capital gain, where the same profit would otherwise be ordinary income if the corporation had realized it in the regular course of business or if the enterprise had been individually owned and operated. All the examples given in the hearings and committee reports involve precisely this kind of income, and no other. The examples on the building industry are conspicuously concerned

only with profits which are normally realized as ordinary income in the regular course of business. See pp. 30-31, 33-35, *supra.*

A corporation, then, is not collapsible merely because it was formed or availed of for the construction of property. Nor is it collapsible because there is a sale of stock or a liquidation before it realizes a substantial part of the net income to be derived from the property. A corporation is collapsible only if construction proceeded with a view to the shareholders' realization of gain attributable to the constructed property. And that proscribed gain is the profit which would be realized as normal business income, subject to ordinary tax, in the absence of the attempt "to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains." See p. 27, *supra.* "On this point the legislative history is decisive." The hearings and the committee reports are "an authoritative gloss." *Utah Junk Co.* v. *Porter*, 328 U.S. 39, 42 (1946). See also *Commissioner* v. *Bilder, supra,* at 503.

By the same token, Springfield and Hill were not collapsible corporations. For they were not used as a means of realizing the gain contemplated by the statute. The development was property used in a trade or business. If the corporations had directly sold the development, the profit would have been a capital gain. Int. Rev. Code of 1939, § 117(j). Again, if the petitioners had directly owned and sold the development, the profit would also have been a capital gain. *Ibid.* See pp. 3-6, and 21, *supra.* The Commissioner himself tacitly concedes, in light of the findings and uncontradicted evidence, that the petitioners "would have been entitled to capital-gains treatment had they con-

ducted the enterprise in their individual capacities without utilizing a corporation." Brief for Resp. on Pet. for Cert., p. 2.[7] The sale of the stock instead of the assets simply produced a similar capital gain.[8] At the same time, the corporations continued to realize the ordinary income from the property as ordinary income. In the very relevant words of this Court, the gain on the sale was "the realization of appreciation in value." It was not a conversion of profits "from the everyday operation of a business." See pp. 23-26, *supra*. Or, in the language of the President, there was no attempt whatever "to take unfair advantage of the difference between the tax rates on ordinary income and the lower tax rates on capital gains." See p. 27, *supra*. Since the gain was not a disguised realization of ordinary income from the constructed property, it was not "gain attributable to such property" within the meaning of section 117(m). Hence the Commissioner cannot tax the gain on the sale as ordinary income realized through a collapsible corporation. *United States* v. *Ivey*, *supra*.

To restate our conclusion, the statute was deliberately aimed at the conversion of ordinary income into capital gain. What the court below has done is

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[7] In this connection the Tax Court specifically found, as the Commissioner stipulated, that the petitioners' shares in Springfield and Hill were not stock in trade, inventory, or property held primarily for sale to customers in the ordinary course of trade or business. (R. 19.)

[8] A portion of the gain was formally realized through distributions shortly preceding the sale. But as the court below held, the distributions were "part of the sale transaction" (R. 22), and it so treated them in its legal analysis. They were made pursuant to the terms of the sale and at the insistence of the buyers. See p. 5, *supra*.

to convert capital gain into ordinary income. It has very effectively turned section 117(m) into a penal levy. Taxpayers who have not engaged in any tax avoidance are punished for having held property through a corporation rather than as individuals.

II. The Court of Appeals Misconstrued the Words "Gain Attributable to Such Property"

The Court of Appeals recognized that if our view of the statute is correct, then Springfield and Hill were not collapsible corporations. But the court rejected our interpretation on the ground that section 117(m) "as literally written applies regardless of whether the assets constructed by the corporation would have produced capital gain or ordinary income if constructed and sold by the shareholder." (R. 35-36.) As this conclusion indicates, the court invoked the so-called "letter" of the statute. At the same time, however, the court conceded that its conclusion made little sense. See pp. 57, 68-69, *infra*.

The court's resort to "literalism" consists of two errors—quite apart from the absurdity of the result. First, the court gratuitously assumed that gain attributable to the constructed property, as contemplated by the statute, "literally" means only what the court thought it meant. Second, even if this "literal" assumption were correct, the court egregiously erred in ignoring the plain-spoken purpose and policy of section 117(m). Judge Learned Hand has wisely said, "There is no more likely way to misapprehend the meaning of language—be it in a constitution, a statute, a will or a contract—than to read the words literally, forgetting the object which the document as a whole is meant to secure." *Central Hanover B. & T. Co.* v.

Commissioner, 159 F. 2d 167, 169 (2d Cir. 1947). It would be hard to find a better case to illustrate this perceptive observation.

To seek aid and comfort from the "literal" meaning of the statute is merely to engage in obvious question-begging. For this mode of reasoning quietly assumes what it supposedly seeks to establish—that the phrase in question necessarily has only one intrinsic meaning, regardless of its particular context or purpose. This Court "long ago rejected" such mechanical notions of construction as "mischievous and misleading." *ICC* v. *J-T Transport Co.*, 368 U.S. 81,107 (1961) (dissent). See also *Association of Westinghouse Salaried Employees* v. *Westinghouse Elec. Corp.*, 348 U.S. 437, 444 (1955). "Anything that is written may present a problem of meaning, and that is the essence of the business of judges in construing legislation. The problem derives from the very nature of words. They are symbols of meaning. But unlike mathematical symbols, the phrasing of a document, especially a complicated enactment, seldom attains more than approximate precision. If individual words are inexact symbols, with shifting variables, their configuration can hardly achieve invariant meaning or assured definiteness." Frankfurter, *The Reading of Statutes*, in Of Law and Men 44, 45 (1956).

According to the court below, "gain attributable to such property" embraces any profit realized on a sale of stock, regardless of the nature of the profit or its relation to the ordinary income produced by the property. This view of the words the court then described as "literally" required. In short, the court maintained that the words inherently could not mean anything else. Mr. Justice Holmes neatly disposed of such

wooden construction—if construction it can be called—in an oft-quoted sentence. "A word is not a crystal, transparent and unchanged; it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used." *Towne* v. *Eisner*, 245 U.S. 418, 425 (1918). The meaning of words is shaped by the context in which they are used. The same word does not always express the same idea. "The word to be defined, in common with words generally, will have a color and content that will vary with the setting." *Hawks* v. *Hamill*, 288 U.S. 52, 57 (1933). See also *International Stevedoring Co.* v. *Haverty*, 272 U.S. 50, 52 (1926); *Boston Sand & Gravel Co.* v. *United States*, 278 U.S. 41, 46-47 (1928); *Jarecki* v. *Searle & Co.*, *supra*, at 307. Hence the same word may have different meanings in different parts of the same statute. *Lamar* v. *United States*, 240 U.S. 60, 65 (1916).

In taxation, too, "most words admit of different shades of meaning, susceptible of being expanded or abridged to conform to the sense in which they are used." *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84, 87 (1934). And so the same word or phrase may have diverse meanings in diverse contexts. See, *e.g.*, *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 5 (1932); *United States* v. *Murdock*, 290 U.S. 389, 394 (1933); *United States* v. *Stewart*, 311 U.S. 60, 69 (1940); *Higgins* v. *Commissioner*, 312 U.S. 212, 217 (1941); *United States* v. *Pyne*, 313 U.S. 127, 131 (1941); *Helvering* v. *Reynolds*, 313 U.S. 428, 433 (1941). "The same meaning need not always be attributed to a phrase which, by hypothesis, has more than one meaning for purposes of statutory construction." *Helvering* v. *Morgan's, Inc.*, 293 U.S. 121, 128

(1934). Indeed, in tax law it is peculiarly fitting that the courts should carefully guide themselves by the purpose and context of the words involved. The meaning of a term "in a setting as complex as that of the revenue acts, however precise its language," cannot be properly ascertained "if the mind be isolated from the history of the income tax legislation of which it is an integral part." *Helvering* v. *Morgan's, Inc., supra*, at 126. See also *Spies* v. *United States*, 317 U.S. 492, 497 (1943); *Jarecki* v. *Searle & Co., supra*, at 307. Only recently the same words in successive tax statutes, dealing with the very same subject, were construed differently in view of "the Congressional purpose explicitly revealed in the House and Senate Committee Reports on the bill." *Commissioner* v. *Bilder*, *supra*, at 502. See also *Turnbow* v. *Commissioner*, 368 U.S. 337 (1961), where the Court made short shrift of the "literal" mode of construction. As the Court observed, on the basis of "plain words" both parties had made "plausible arguments" for "diametrically opposed conclusions." *Id.* at 339.

Legislative history is all the more significant where the application of a statute turns on such a protean concept as gain—whether it be the realization of a gain or the nature of a gain. See, *e.g.*, the majority and minority opinions in *Commissioner* v. *Crane*, 331 U.S. 1 (1947); and *Commissioner* v. *Wodehouse*, 337 U.S. 369 (1949). Compare *Bowers* v. *Kerbaugh-Empire Co.*, 271 U.S. 170 (1926), with *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931); and see *Dobson* v. *Commissioner*, 320 U.S. 489 (1943), *rehearing denied*, 321 U.S. 231 (1944). Compare further Mr. Justice Holmes' opinions in *Towne* v. *Eisner*, *supra*, at 426-427, and *Eisner* v. *Macomber*, 252 U.S. 189, 219-220

(1920). See generally Magill, Taxable Income (rev. ed. 1945). "Large concepts like 'property' and 'ownership' call for close analysis, especially when tax legislation is under scrutiny." *Whitney* v. *State Tax Commission*, 309 U.S. 530, 538 (1940). The concept of gain requires the same searching scrutiny. Like "property" and "ownership", it suggests a delusive exactness. Even a statutory term like "gross income" has a variable content, depending on its context in a particular case. Compare *United States* v. *Benedict*, *supra*, with *Helvering* v. *Bliss*, 293 U.S. 144 (1934); *Emma B. Maloy*, 45 B.T.A. 1104 (1941); *James M. McDonald*, 23 T.C. 1052 (1955); Rev. Rul. 56-191, C.B. 1956-1, 636. If there is no illuminating legislative history "which expressly settles the course to be followed," this Court will nevertheless "seek the purposes of the applicable sections of the Code and adopt that construction which best gives effect to those purposes." *United States* v. *Benedict*, *supra*, at 696. It refuses to take refuge in an evasive "literalism." In *Helvering* v. *Estate of Enright*, 312 U.S. 636, 643 (1941), this Court held that even the word "accrue," which is a staple term in accounting and taxation, is not "a word of art with a definite connotation when employed in describing items of gross income." And, as the Government successfully argued, the word was carefully read in accordance with Congress' purpose, though the meaning placed upon the word departed from its usual import. Cf. *Estate of Putnam* v. *Commissioner*, 324 U.S. 393, 397 (1945).

Words, then, are "inexact tools". Hence, no matter how "clear" a statute may seem on a hasty reading or superficial examination, nothing precludes the use of legislative materials in aid of its construction. See

Boston Sand & Gravel Co. v. *United States*, *supra*, at 46-48; *United States* v. *American Trucking Assns.*, 310 U.S. 534, 542-544 (1940); *Harrison* v. *Northern Trust Co.*, 317 U.S. 476, 479 (1943). "It would be anomalous to close our minds to persuasive evidence of intention on the ground that reasonable men could not differ as to the meaning of the words." *United States* v. *Dickerson*, 310 U.S. 554, 562 (1940). This Court has well said that questions of construction often emerge "where upon first reading the words seem clear. Generally, questions as to the meaning intended do not arise until the language used is compared with the facts or transactions in respect of which the intent and purpose are to be ascertained." *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 465 (1934). In final analysis, despite all efforts to reduce construction to a mechanical process, the controlling principle is that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." *S.E.C.* v. *Joiner Leasing Corp.*, 320 U.S. 344, 350-351 (1943). "The meaning to be ascribed to an Act of Congress can only be derived from a considered weighing of every relevant aid to construction." *United States* v. *Dickerson*, *supra*, at 562.

The same principle applies no less to tax statutes than other statutes. *Haggar Co.* v. *Helvering*, 308 U.S. 389, 394 (1940). The application of a revenue provision "is not an exercise in framing abstract definitions." *Bazley* v. *Commissioner*, 331 U.S. 737, 741 (1947). Tax statutes, like other statutes, "derive vitality from the obvious purposes at which they are

aimed." *Griffiths* v. *Commissioner*, 308 U.S. 355, 358 (1939). As Mr. Justice Sutherland wrote in a leading case on the construction of tax statutes, the "intention of the lawmaker controls in the construction of taxing acts as it does in the construction of other statutes." *Helvering* v. *Stockholms Enskilda Bank*, *supra*, at 93. See also *Commissioner* v. *Wodehouse*, *supra*, at 379.

The question here is not what the words in issue may mean as an abstract matter. The question is what they mean as concretely used in section 117(m). See *Jarecki* v. *Searle & Co.*, *supra*, at 307. And the phrase as used there "must draw its meaning from its function in that section." *Bazley* v. *Commissioner*, *supra*, at 740. When the right question is asked, the right answer readily follows. The meaning of the words involved here is unmistakably disclosed in the "authoritative pronouncements" made in the hearings and the committee reports. Cf. *Commissioner* v. *Bilder*, *supra*, at 503. Legislative words are obviously written with some purpose in mind. Therefore, they are appropriately construed in response to the problems they were designed to solve and the result they were designed to effect. The explanatory statements of those who conceive and draft a statute are the most significant indicia of what the statute means. See Landis, *A Note on "Statutory Interpretation,"* 43 Harv. L. Rev. 886, 888 (1930); Jones, *Statutory Doubts and Legislative Intention*, 40 Col. L. Rev. 957, 967 (1940).

To summarize our position at this point, there is no question here of doing violence to the "literal" language of the statute. For here we are considering a flexible phrase whose connotation depends on the context in which it appears. And the meaning of that phrase, as it is used here, "is to be ascertained, not

by taking the word or clause in question from its setting and viewing it apart, but by considering it in connection with the context, the general purposes of the statute in which it is found, the occasion and circumstances of its use, and other appropriate tests for the ascertainment of the legislative will." Once Congress' objective is "thus disclosed, it is enough that the word or clause is reasonably susceptible of a meaning consonant therewith, whatever might be its meaning in another and different connection." *Helvering v. Stockholms Enskilda Bank*, *supra*, at 93-94. In the *Stockholms Enskilda* case, unlike the present case, there were no committee reports or other authoritative statements which expressly spelled out the policy of Congress.[9] See also *Commissioner* v. *Wodehouse*, *supra*, at 377-380; *Jarecki* v. *Searle & Co.*, *supra*, at 307.

The Court has criticized the kind of interpretation which removes a few words from their setting, and

[9] In the *Stockholms-Enskilda* case the Government was far more sensitive to legislative policy than it has managed to be here. The question there was whether interest on a tax refund, paid by the United States to a foreign corporation, was taxable as "interest on bonds, notes, or other interest-bearing obligations of residents, corporate or otherwise," of the United States. The Government prevailed on the basis of the policy of the statute. The Court held that the United States was a "resident" of the United States for purposes of the statute. The opinion states, "While it cannot be said that the United States, in its corporate capacity as an artificial person, has a bodily presence in any place, it is not unreasonable to hold that in the eye of the law it has a residence, and especially so when a contrary holding would defeat the evident purpose of a statute." 293 U. S. at 91-94. Compare *United States* v. *Cooper*, 312 U. S. 600 (1941), with *Georgia* v. *Evans*, 316 U. S. 159 (1942), involving a similar interpretative issue over the word "person." And see *Parker* v. *Brown*, 317 U. S. 341, 351 (1943), which attributes the diverse interpretations of the same word to "the purpose, the subject matter, the context and the legislative history" of the particular statute.

then proceeds to construe them as so isolated. See *United States* v. *American Trucking Assns., supra*, at 542. At times this sort of construction produces a conclusion that it "would appear senseless for Congress to adopt." *Jarecki* v. *Searle & Co., supra*, at 308. This is precisely what has happened here. And so the court below arrived at the strange conclusion that a statute designed to prevent the conversion of ordinary income into capital gain has just the opposite effect of converting capital gain into ordinary income.

We have argued that this case does not present any problem of "literal" meaning. The phrase "gain attributable to such property" derives its content from its context. However, the correct answer is the same even if we erroneously assume that the phrase "literally" means what the Court of Appeals imputed to it. Under that "literal" view, we have seen, the gain attributable to the property includes any profit realized on the sale of stock, regardless of the economic content of the profit. It makes no difference whether the profit constitutes a conversion of normal business income or a realization of a true capital gain. And, as we further understand this "literal" rendition, there is no choice but to submit to it in helpless fashion, though it fails to make sense.

Fortunately, this Court has refused to acquiesce in such sterile notions of statutory construction. It has definitively disapproved "a literal interpretation dogma which withholds from the courts available information for reaching a correct conclusion." *United States* v. *American Trucking Assns., supra*, at 544. See also *Association of Westinghouse Salaried Employees* v. *Westinghouse Elec. Corp., supra*, at 444. To construe a statute is to ascertain its meaning, and that

meaning is to be determined in the light of its history and purpose. "The decisions of this Court have repeatedly warned against the dangers of an approach to statutory construction which confines itself to the bare words of a statute," for "literalness may strangle meaning." *Lynch* v. *Overholser*, 369 U.S. 705, 710 (1962); *Utah Junk Co.* v. *Porter, supra*, at 44. In the words of Mr. Justice Frankfurter, "The notion that because the words of a statute are plain, its meaning is also plain, is merely pernicious oversimplification. It is a wooden English doctrine of rather recent vintage . . . to which lip service has on occasion been given here, but which since the days of Marshall this Court has rejected, especially in practice." *United States* v. *Monia*, 317 U.S. 424, 431 (1943) (dissent).

Therefore, no matter how "plain" the words may be, the Court will not read them so as to produce absurd, harsh, or incongruous results. Even when the bare words do not entail an absurd result, but an unreasonable one, "plainly at variance with the policy of the legislation as a whole," the Court refuses to indulge in blind literalness or to sacrifice common sense. See, *e.g.*, *United States* v. *American Trucking Assns., supra*, at 543; *Church of the Holy Trinity* v. *United States*, 143 U.S. 457, 459 (1892); *Haggar Co.* v. *Helvering, supra*, at 394-95; *Textile Mills Securities Corp.* v. *Commissioner*, 314 U.S. 326, 333-334 (1941); *Markham* v. *Cabell*, 326 U.S. 404, 409 (1945). As the Court stated in *Ozawa* v. *United States*, 260 U.S. 178, 194 (1922), "we must examine the matter further. We may then look to the reason of the enactment, and inquire into its antecedent history, and give it effect in accordance with its design and purpose, sacrificing, if necessary, the literal meaning in order that the purpose

may not fail." The short of the matter is that "all laws are to be given a sensible construction". An outlandish or incongruous reading should be sedulously avoided whenever the statute can be reasonably applied, "consistent with the legislative purpose." *United States* v. *Katz*, 271 U.S. 354, 357 (1926); *United States* v. *Kirby*, 7 Wall. 482, 486 (1869).

In so far as we are aware, this principle fully applies to tax statutes. See *Haggar Co.* v. *Helvering*, *supra*, at 394. Even revenue laws should be read so as to make sense—especially when Congress and the Treasury have clearly and cogently indicated the sense to be made. The construction of statutes is not a game in which the purpose is to display verbal ingenuity for the sake of the highest possible tax, in bland disregard of Congress. It is a painstaking effort to apply the words of Congress as Congress meant them to be applied.

We are only saying what the Government itself repeatedly urges before the Court—and successfully so. For example, in a series of cases on corporate reorganizations the Court "has withheld the benefits of the reorganization provision in situations which might have satisfied provisions of the section treated as inert language, because they were not reorganizations of the kind" with which the statute "in its purpose and particulars concerns itself." *Bazley* v. *Commissioner*, *supra*, at 741. As Mr. Justice Douglas put it, "a transaction may not qualify as a 'reorganization' under the various revenue acts though the literal language of the statute is satisfied." *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 182 (1942). See further *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *LeTulle* v. *Scofield*, 308 U.S. 415

(1940). Even in an area so diverse and complex as corporate reorganizations, "the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes, and no degree of particularity can ever obviate recourse to the setting in which all appear, and which all collectively create." A reorganization is not necessarily a tax-free transaction, "though the facts answer the dictionary definitions of each term used in the statutory definition." The meaning of each term is to be derived from the purpose of the statute and its "underlying presupposition." *Helvering* v. *Gregory*, 69 F. 2d 809, 810-811 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

Even more important here, the Court has similarly construed the basic provisions on capital gains. Various gains have been denied capital gain treatment in accordance with legislative history and policy, though the statutory language, abstractly considered, is easily broad enough to encompass such gains. See pp. 23-26, *supra*. In *Corn Products Co.* v. *Commissioner*, *supra*, the Court readily agreed that "the literal language" of section 117(a) did not exclude the property in question from the definition of "capital assets". But it nevertheless held that the statute "must not be so broadly applied as to defeat rather than further the purpose of Congress." Therefore, the special treatment for capital gains did not apply to gains representing profits "arising from the everyday operation of a business," as distinguished from transactions "which are not the normal source of business income." 350 U.S. at 51-52. As the Court later stated, "not everything which can be called property in the ordinary sense and which is outside the statutory exclusions qualifies as a capital asset." *Commissioner* v. *Gillette Motor Transport*, *supra*, at 134.

What is true of section 117(a) is necessarily just as true of section 117(m). For subsection (m) is merely a policing provision that was designed to safeguard the policy expressed in subsection (a). The purpose of subsection (a) is to draw a line between profits from the everyday operation of a business and profits from appreciation accrued over a period of time. The purpose of subsection (m) is to hold that same line against schemes which would make inroads upon it through the adroit use of a corporation. If subsection (a) makes no attempt to tax profits from appreciation as ordinary income, how, then, can any purpose to do so be reasonably attributed to subsection (m)? Since the aim of subsection (m) is to sustain the purpose of subsection (a), we labor the obvious when we say that both are animated by the same purpose. And to disregard that purpose is to assume that subsection (m) must be "so broadly applied as to defeat rather than further the purpose of Congress." Such assumptions should not be gratuitously attributed to Congress.

As Judge Learned Hand wrote, after many years of thoughtful concern with legislation, "statutes always have some purpose or object to accomplish, whose sympathetic and imaginative discovery is the surest guide to their meaning." *Cabell* v. *Markham*, 148 F. 2d 737, 739 (2d Cir. 1945), *aff'd*, 326 U.S. 404 (1945). This cardinal principle of interpretation is commonly applied in behalf of the Government. See pp. 50-51, *supra*. See also *Helvering* v. *Clifford*, 309 U.S. 331 (1940); *Commissioner* v. *Wodehouse*, *supra*; *United States* v. *Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81-85 (1960); *Jarecki* v. *Searle & Co.*, *supra*, at 309-313. The same principle no less prevails when an unduly "literal" reading would inflict a "harsh and incon-

gruous result" on the taxpayer. *Haggar Co.* v. *Helvering, supra,* at 395. See also *Helvering* v. *New York Trust Co., supra,* at 464-465. It is not a one-way street generously provided for the sole convenience of the Government. In one case, as in the other, the taxing statute "must be construed with reference to" its "presuppositions and purpose." *Bazley* v. *Commissioner, supra,* at 740. While at times the purpose of Congress is obscure, no such excuse can be pleaded here.

Again we are only saying what the Government itself has said on another occasion. In Rev. Rul. 56-50, C.B. 1956-1, 174, the Commissioner carefully probed the question whether the definition of a collapsible corporation should be construed in "literal" fashion or in accordance with its intended purpose. Two individuals owned the stock of a corporation which, in turn, owned the stock of five subsidiaries. Each subsidiary built and operated a housing development. The parent sold its stock in all five subsidiaries. The two individuals next proposed to liquidate the parent. The question before the Treasury was whether the gain realized by the stockholders on the liquidation would be taxable as ordinary income on the ground that the parent was a collapsible corporation. It was assumed, for the purpose of resolving this issue, that the five subsidiaries were collapsible corporations, and therefore the gain realized by the parent on the sale of their stock was ordinary income.

The definition of a collapsible corporation includes a holding company as well as an operating company. The relevant words are "a corporation formed or availed of principally for the . . . construction . . . of property, or *for the holding of stock in a corporation so formed or availed of,* with a view to . . . the sale or

exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation . . . constructing . . . the property of a substantial part of the net income to be derived from the property." (Italics supplied.) This definition, the Commissioner observed, refers only to the realization of income by the corporation producing the property, as distinguished from the holding company. "If, prior to such realization, the parent and subsidiary corporations are both liquidated or the stock of the parent corporation is sold," the provision is "automatically applicable to the parent corporation." *Id.* at 175. "A literal reading of the statute," the Commissioner then stated, "would seem to produce the same result even though the parent corporation had first realized ordinary income by virtue of its sale of the entire stock of the subsidiary. Since the statute refers only to the realization of taxable income by the corporation producing the property, and not to any realization by the corporation holding its stock, it would appear under the literal language of the statute that the corporation holding stock of a collapsible corporation would still be a collapsible corporation even though it had been taxed as the shareholder of a collapsible corporation." *Ibid.*

However, the Commissioner refused to yield helplessly to a "literal reading" of the statute. To apply the statute twice to the same property, he reasoned, "would extend the statute beyond its intended purpose." The legislative history of section 117(m) "makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." *Id.* at 175-176. After referring to

the committee reports, the Commissioner continued as follows: "Where ordinary income is realized at the corporate level by the sale of the stock of a collapsible subsidiary, the evil at which the statute was aimed is not present and the effect of the literal interpretation suggested earlier would be to impose what would amount to a penalty tax at the shareholder level through requiring the gain attributable to property produced by a collapsible subsidiary to be taxed at both levels as ordinary income. There is no evidence in the legislative history that Congress intended such a result. Thus, it would be unreasonable to adopt the suggested literal interpretation." *Id.* at 176.[10]

While Rev. Rul. 56-50 dealt with a different part of the statute defining a collapsible corporation, the ruling is nevertheless highly significant here. First, the Commissioner ruled that the statute should be meticulously construed in response to "the evil at which the statute was aimed," even if it "literally" reads otherwise. The section should not be extended "beyond its intended purpose." Second, the Commissioner very precisely summarized the "intended purpose" which determines the appropriate application of section 117(m). In his own words again, the legislative history "makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." And in the light of that "clear" purpose, the Commissioner rightly refused to apply

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[10] In support of his decision to apply the statute in accordance with its purpose, the Commissioner cited this Court's opinions in *Church of the Holy Trinity* v. *United States*, *supra*; *Helvering* v. *New York Trust Co.*, *supra*; *Huggar Co.* v. *Helvering*, *supra*; and *United States* v. *American Trucking Assns.*, *supra*.

the section in the case before him. Otherwise he would have imposed an "unreasonable" result "beyond its intended purpose."

Here it should be much easier for the Commissioner to exercise his aversion to "literalness" than in the case just summarized. There the Commissioner was obliged to supply, through the process of construction, an omission which the draftsmen had overlooked. In order to reach a proper conclusion, he had to infer the presence of missing words. Cf. *St. Louis-San Francisco Ry.* v. *Middlekamp*, 256 U.S. 226, 232 (1921). Here, in distinct contrast, there is no problem of supplying an omission. The question is simply one of properly construing a phrase which is explicitly in the statute.[11]

Once "the tyranny of literalness is rejected" (*United States* v. *Witkovich*, 353 U.S. 194, 199 (1957)), the proper result here is also immediately apparent. Springfield and Hill were not collapsible corporations because they were not—in the Commissioner's words—"a device for converting ordinary income into long-term capital gain through the medium of a corporation." If the petitioners had owned the development as individuals, the gain realized on the sale would have been a long-term capital gain. See pp. 38-39, *supra*. On the other hand, if section 117(m) is applied

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[11] For another example where the Commissioner refused to be "literal", see Rev. Rul. 56-104, C.B. 1956-1, 178. Under section 117(m) the definition of a collapsible corporation turns, in part, on the corporation's failure to realize net or taxable income before the sale of the stock. See p. 20, *supra*. In Rev. Rul. 56-104 the Commissioner held that a foreign corporation was not a collapsible corporation, although "for Federal income tax purposes" it could not realize any net or taxable income.

here on the pretext of "literalness," the result will be harsh and incongruous, as well as plainly absurd. It will squarely contradict the result so clearly contemplated by Congress. Instead of preventing the conversion of ordinary income into capital gain, the Commissioner will harshly penalize the petitioners by converting capital gain into ordinary income. They will be severely punished merely because they owned the property through corporations rather than as individuals. In fact, the court below expressly conceded that its "literal" understanding of the statute "produces unwarranted taxation of capital gains as ordinary income." (R. 36.) To use the Commissioner's apt words again, "the evil at which the statute was aimed is not present." The deficiencies asserted by him would inflict "what would amount to a penalty tax." See p. 55, *supra*. Certainly, the result sought by the Commissioner hardly reflects that "sympathetic and imaginative" spirit in which statutes should be read and applied.

Our conclusion is amply fortified by *United States v. Ivey, supra*, which construed section 341 of the 1954 Code—the successor to section 117(m). In the *Ivey* case the Fifth Circuit held the that the statute does not apply to "taxpayers who would have been entitled to capital gains treatment, without having incorporated." It "does not penalize the taxpayer by converting his capital gain into ordinary income." Moreover, the Court declared, the Commissioner's construction "would make nonsense of the statute." The legislative history "shows beyond dispute that the mischief" at which it aimed "was the taxpayers' abuse of the corporate device as a technique for transmuting ordinary income into capital gains. Only by reading this

purpose into the words of the law can it be said that the law has a plain meaning." "The corrective statute was designed to collapse the corporate facade and impose the ordinary income treatment which the transactions deserve." "Carefully defined principles have been evolved for determining the circumstances under which income should receive capital gains treatment. The determination rests primarily on the character of the gain and the relation of the nature of the gain to the nature of the taxpayer's business. The collapsible corporation provisions conform with these prinsiples. It would be ironic if the provisions were construed to require earnings which ordinarily should be capital gains to be treated as ordinary income." 294 F. 2d 799, 802-804 (5th Cir. 1961).

"There is no way," the Fifth Circuit emphasized, "to fit in such a result with a rational pattern of capital gains taxation. If, for tax purposes, the corporate form is ineffective and the court should pierce the corporate veil, the gains should be attributed directly to the shareholder. In such a case they should be capital gains, if the individual is entitled to capital gains treatment. If, on the other hand, the court should not pierce the corporate veil, the sale of the shareholder's stock should be treated as if it were the sale of any other capital asset. To construe this statute to make the taxpayer's profits taxable as ordinary income, even though in the absence of a corporation they would have been capital gains, would be to carve out a special group of cases for special treatment inconsistent with that accorded capital gains generally." The opinion concludes that the statute "should not be read as applicable to cases where the shareholder's gain would be taxable as a capital gain had he realized it directly

rather than through the corporate vehicle." Any attempt to apply it in that situation would necessarily impose an irrational hardship. *Id.* at 804-805.

Of course, we are not suggesting that there is any discrepancy here between the "letter" of the statute and the plain-spoken purpose of Congress. As we have argued, the phrase "gain attributable to such property" is not a term of art with some fixed meaning acquired over many years. It is a flexible term that derives its content from its context. *Cf. International Stevedoring Co.* v. *Haverty*, *supra*, at 52. And here it "came freighted with the meaning imparted to" it "by the mischief to be remedied and by contemporaneous discussion." *Duparquet* v. *Evans*, 297 U.S. 216, 221 (1936). The phrase is part of a special statute drawn for a specific purpose. "A few words of general connotation appearing in the text of statutes should not be given a wide meaning contrary to a settled policy, 'excepting as a different purpose is plainly shown.'" *United States* v. *American Trucking Assns.*, *supra*, at 544. As the Court recently emphasized in a tax case, a word of variable meanings should be interpreted so as "to avoid the giving of unintended breadth to the Acts of Congress." *Jarecki* v. *Searle & Co.*, *supra*, at 307. The controlling purpose here is clearly spread and elaborated on the legislative record, and that purpose is embedded in the settled policy which this Court has carefully fulfilled over the years. See pp. 23-26, *supra*. To sever the statute from that purpose is to mutilate the statute.

In any event, regardless of how "plain" the phrase may otherwise seem, it should be closely construed in accordance with Congress' purpose, and the Treasury's purpose as contemporaneously expressed to Congress.

Courts are particularly sensitive to any effort to impute "absurd results" to "words of *general meaning.*" This is "a case where there was presented a definite evil, in view of which the legislature used general terms with the purpose of reaching all phases of the evil." *Church of the Holy Trinity* v. *United States, supra,* at 472. Given the clear purpose of the section, our conclusion is the only natural and appropriate one. The words of the statute should not be bent so as to distort that purpose. Neither the hearings nor the reports reveal the slightest desire to tax; as ordinary income, profits which are otherwise normally realized as capital gains. "Nowhere in the reports of the Committees does it appear that any such novel legislation was being proposed as is here contended for by the government." *United States* v. *Katz, supra,* at 360. If we may somewhat revise a well-known dictum of Mr. Justice Holmes, the words used by Congress should not be assiduously pursued to a drily illogical extreme.

III. The Petitioners' Position Is Confirmed By Other Provisions of the Statute

Our conclusion is not only sustained by the purpose of Congress, so clearly articulated in the hearings and committee reports. It is also several times confirmed by the scheme and structure of section 117(m). We are not concerned here with a single phrase or term in an isolated sentence, but with a group of words which are entwined with other segments of an elaborate statute. *Cf. Flora* v. *United States*, 362 U.S. 145, 157 (1960). "There is need to keep in view also the structure of the statute, and the relation, physical and logical, between its several parts." *Duparquet* v. *Evans, supra,* at 218. See also *Richards* v. *United States, supra,* at 11. This is particularly true of tax legislation,

"however precise its language." *Helvering* v. *Morgan's, Inc., supra*, at 126. The phrase to be construed here "does not stand alone, but gathers meaning from the words around it." *Jarecki* v. *Searle & Co., supra*, at 307.

A collapsible corporation is "a corporation formed or availed of principally for the . . . construction . . . of property . . . with a view to" the shareholders' realization of "gain attributable to such property." The "view" and "gain," then, are interrelated elements of one over-all rule of law created by the statute. The meaning of the statute is accordingly illuminated by their mutual relationship.

Clearly, section 117(m) is one of many statutes "in which purpose or state of mind determines the incidence of an income tax." *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 289 (1938). *Cf. Commissioner* v. *Culbertson*, 337 U.S. 733, 743 (1949). The words "with a view to" predicate liability on "a state of mind which must attend and gives significance to certain action." *Jacobson* v. *Commissioner*, 281 F. 2d 703, 705 (3d Cir. 1960). That state of mind is the purpose to obtain the proscribed gain.

The phrase "with a view to" is colloquial English with a familiar meaning. According to common understanding, it means "with the purpose or aim of" or "calculating upon or contemplating as a desired result." Webster, New International Dictionary (2d ed. unabridged, 1948); Fowler, A Dictionary of Modern English Usage 693 (1947); Nicholson, A Dictionary of American-English Usage 629 (1957). See also *Mortensen* v. *United States*, 322 U.S. 369, 373-374 (1944), where the Court used "with a view toward" as synonymous with "for the purpose of," "with the

intent and purpose," and "intention and motivation." Nothing in the legislative history of section 117(m) suggests or implies that the phrase expresses any concept other than this ordinary and everyday meaning. On the contrary, according to the legislative history the phrase was used as it is usually understood in intelligent discourse. Again and again the collapsible corporation is described as "a device"—something which is purposefully used or contrived for a desired end. See pp. 27-35, *supra*. "The existence of the defined purpose is a condition precedent to the imposition of the tax liability" imposed by the statute. *Helvering* v. *National Grocery Co., supra,* at 289.

We need hardly add that "with a view to" necessarily limits the statute to construction specifically prompted by the desire to obtain the gain attributable to the construction. A corporation is collapsible only if used for construction as a calculated means of realizing that benefit. As the Treasury repeatedly emphasized before the Ways and Means Committee, section 117(m) is solely concerned with abnormal behavior inspired by that advantage. See pp. 27-34, *supra*. Like section 102,[12] it is directed against the studied departure from normal corporate enterprise "to avoid taxes." *United Business Corporation* v. *Commissioner,* 62 F. 2d 754, 756 (2d Cir. 1933), *cert. denied,* 290 U.S. 635 (1933). See also *id.,* 19 B.T.A. 809, 828 (1930).

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[12] Section 102 of the 1939 Code is a special tax on corporations "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed." See *Helvering* v. *National Grocery Co., supra; Helvering* v. *Chicago Stock Yards Co.,* 318 U.S. 693 (1943). Section 102 has been succeeded by sections 531 and 532 of the 1954 Code.

All the emphasis on purpose or motive, within and without the statute, plays a vital role in its meaning and application. It is designed to make sure that the statute is closely confined to corporations that are intentionally used to secure the proscribed gain through a sale or exchange of stock. Therefore, that gain must be some special advantage not obtainable in normal fashion by the corporation itself or by the shareholders as direct owners of the enterprise. And that advantage or gain can only be profit that constitutes an attempted conversion of ordinary income into capital gain. Otherwise the pronounced emphasis on purpose or motive makes little sense. For the statute is then read as saying that a corporation is collapsible if it is calculatedly used as a means of realizing a capital gain which is otherwise normally realized as a capital gain. We are at a complete loss to understand why Congress would pass a statute which is so devoid of rhyme or reason. Nor did the court below make any effort to supply any explanation.

Another part of the statute—clause (i) of section 117(m)(2)(A)—is equally revealing. Under that clause, a corporation, if it is to be deemed collapsible, must be formed or used for construction with a view to "the sale or exchange of stock by its shareholders" before the corporation itself realizes "a substantial part of the net income to be derived from the property." See p. 20, *supra*. As the committee reports indicate, this "net income" is the normal profit to be derived from the property in the ordinary course of the business. The special provision on this "net income" from the property significantly reinforces our construction of "gain attributable to such property."

The committee reports describe a collapsible corporation as "a device whereby one or more individuals attempt to convert the profits from their participation in a project from income taxable at ordinary rates to long-term capital gain taxable only at the rate of 25 percent." *They point out that in the* absence of this "device", a "legitimate corporation" engaged in business "would pay ordinarily the corporate income tax on its net income." Where the "device" is used, "the corporation pays no tax, claiming that it has realized no income." After summarizing the statute, the reports state that a collapsible corporation "is so defined as to include corporations lending themselves to the attempted tax-saving practice outlined above," namely, the attempted conversion of "income taxable at ordinary rates to long-term capital gain" taxable only at 25 percent. Then the reports add: "The corporation, furthermore, has been so defined as to describe corporations different in kind from those which ordinarily liquidate following normal business operations. This objective has been specifically strengthened by the statement made in subparagraph (i) above, to the effect that the sale or exchange or the distribution be made prior to the realization by the corporation of a substantial part of the net income to be derived from the property." H. R. Rep. No. 2319, *supra*, at 56-57, 96-97; Sen. Rep. No. 2375, *supra*, at 45, 88-89.

According to the reports, then, the "net income" so advisedly included in the definition is "the profits" from "participation in a project" which are "taxable at ordinary rates." Again in the language of the reports, they are the profits which are the subject of "the attempted tax-saving practice" of converting ordinary income into capital gain. The collapsible cor-

poration has therefore been defined so as to exclude corporations which have realized a substantial part of such income before the sale or exchange of stock. At that point they have engaged in "normal business operations," subject to the ordinary rates. They have paid "the corporate income tax" that a "legitimate" corporation "would pay ordinarily." *Hence they should not be proscribed as "corporations lending themselves to the attempted tax-saving practice" condemned by the committees.* See also pp. 34-35, *supra*.

In brief, section 117(m) is applied in relation to the amount of "net income" earned and to be earned from the property. And that "net income" is the ordinary business profit realizable by the corporation in its "normal business operations." Compare *Helvering* v. *Elbe Oil Land Development Co.*, 303 U.S. 372, 375-376 (1938); *Darley-Lynde Co.* v. *Alexander*, 51 F. 2d 56, 58-59 (10th Cir. 1931), *cert. denied*, 284 U.S. 666 (1931); G.C.M. 1023, C.B. VI-1, 19, 20 (1927); and see *Commissioner* v. *Southwest Exploration Co.*, 350 U.S. 308, 316 (1956); *Commissioner* v. *Lake*, *supra*, at 264. The statute is in terms of such "net income" in order to compel the corporate realization of substantial profit taxable at ordinary rates. But all this concern with ordinary income at the corporate level is pointless unless the gain proscribed at the stockholder level constitutes such ordinary income converted into capital gain. The construction of the court below rests on the implicit premise that a provision so carefully included serves no purpose.

Still another portion of the statute sheds further light on the nature of the Commissioner's mode of construction. Paragraph (1) of section 117(m) provides that gain realized on a sale of stock in a collap-

sible corporation is taxable as ordinary income. Obviously, the gain is treated as ordinary income in order to compensate for the fact that the same gain would normally be realized and taxed as ordinary income. As the General Counsel of the Treasury explained to the Ways and Means Committee, the statute looks through "the corporation device as a mere sham, organized not for the purpose of carrying on business, but only for the particular purpose of carrying out what we would characterize as tax avoidance." See p. 33, *supra*. Cf. *Moline Properties* v. *Commissioner*, 319 U.S. 436, 439 (1943). The statute accordingly taxes the profit realized by the stockholder as the ordinary income it would have been in the absence of incorporation. Therefore, once more it necessarily follows—if the statute is to be sensibly read—that the gain attributable to the property is gain which constitutes a conversion of ordinary business profit. Why would Congress otherwise tax the gain as ordinary income? See p. 52, *supra*.

All these additional considerations converge to the same conclusion that Springfield and Hill were not collapsible corporations. To put it mildly, the Commissioner would impose "an unreasonable result plainly at variance with the policy of the legislation as a whole." *Ozawa* v. *United States*, *supra*, at 194. To put it more accurately, he would impose a result that is both harsh and absurd. See pp. 56-59, *supra*.

In the felicitous phrasing of Judge Learned Hand, "interpretation is the art of proliferating a purpose which is meant to cover many occasions so that it shall be best realized upon the occasion in question." *Brooklyn Nat. Corp.* v. *Commissioner*, 157 F. 2d 450, 451 (2d Cir. 1946), *cert. denied*, 329 U.S. 733 (1946). See also *Universal Camera Corp.* v. *Labor Board*, 340 U.S.

474, 489 (1951); *United States* v. *Shirey*, 359 U.S. 255, 261 (1959). Here the purpose of Congress is "best realized"—indeed, only realized—by our reading of the statute. The Commissioner's construction would completely disregard that purpose—even at the cost of reducing the statute to an absurdity. Our view has other virtues, too. It "safeguards the interests of the Government" as they were meant to be protected, and it "avoids gratuitous resentment in the relations between Treasury and taxpayer." *Rosenman* v. *United States*, 323 U.S. 658, 663 (1945). For over 40 years gain from the sale of stock has been taxed as a capital gain, not ordinary income. Section 117(m) creates an exception to that principle aimed at a particular abuse of that principle. The statute should not be loosely extended well beyond the target at which Congress very deliberately aimed.

"The problem" in the end "is to stick with the legislative scheme and determine which construction is most consonant with it." Douglas, *Legal Institutions in America*, in Legal Institutions Today and Tomorrow 274, 289 (1959). We submit that our construction of section 117(m) is easily "most consonant with" the scheme of section 117(m). "No calm, fair-minded person can violently disagree with the underlying purpose of legislative and other attempts to prevent the avoidance of tax." By the same token, however, such measures should not be indiscriminately applied as if Congress were engaged in a Herod's massacre. Paul, Studies in Federal Taxation 64-66 (1937). A statute directed against avoidance should be carefully confined to those that it was designed to reach. There has been no avoidance here. The Commissioner has not been deprived of what he was

otherwise entitled to receive. His attempted application of the statute is nothing less than a perversion of its purpose. And it is a perversion that cannot even plead a rational excuse. Statutes are not given a meaning which it "would appear senseless for Congress to adopt." *Jarecki* v. *Searle & Co., supra*, at 308.[13]

IV. The Court of Appeals Misconstrued the Legislative History and Purpose of the Statute

We have analyzed the "literal" construction on which the decision below rests. Evidently, even the Court of Appeals found it less than adequate. Nor is it difficult to understand why the court was not entirely satisfied. To begin with, the court tacitly conceded that if the petitioners had owned the development individually, the gain on the sale would have been capital gain. Next, it frankly confessed that the application of the section in this situation "produces

[13] The Court of Appeals attempts to bolster its "literal" rendition by stating: "The commentators have generally assumed that the collapsible corporation section would be literally interpreted by the courts." (R. 36.) The question here is what the statute meant to Congress, not what others may have feared the courts would do. Needless to add, articles by pessimistic commentators do not justify a tax which the Commissioner cannot otherwise sustain. Furthermore, the Court of Appeals' summary of the commentators' views is quite incomplete. For example, one of the cited authors severely criticized the early decisions of the Tax Court for disregarding the legislative history and policy of section 117(m). As he particularly stated, "presumably the fact that the taxpayer would have enjoyed capital gain on the sale of the corporate property if it had been held and sold by him directly will be no ground for avoiding the application of the Section in the Tax Court. Indeed, in many cases the legislative purpose will be perverted and capital gain will be converted into ordinary income." Anthoine, *Collapsible Corporations; 1957 Developments*, 16 N.Y.U. Inst. on Fed. Taxation 658, 661 (1958).

unwarranted taxation of capital gains as ordinary income." (R. 36.) In a further effort to sustain the deficiencies, the court turned to other grounds for its conclusion. These other grounds are supposed to prove that while the result is "unwarranted," it is nevertheless impeccably correct. However, as we shall now indicate, the opinion scarcely improves as it goes along.

The court first observes that our position rests on a misconception of the statute. "The taxpayers in this case and the Fifth Circuit in *Ivey*," the court states, "assume that the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself. However, the legislative history discloses that Section 117(m) had another major purpose." (R. 36.) The court then discusses two kinds of property not held for sale to customers in the ordinary course of trade or business. The two kinds are a motion picture and an apartment building produced and held for rental. "If an individual made a movie or constructed an apartment building, income received from the rental of the movie or building would be ordinary income. Thus, some taxpayers formed a corporation to make the movie or construct the apartment building and then liquidated the corporation after the movie or the building was finished. On liquidation the shareholders were taxed at capital gain rates on the difference between their basis in the stock and the fair market value of the movie or apartment building, but the shareholders' basis in the movie or apartment building was stepped up to fair market value. The shareholders could then rent out the movie or apartment building and amortize or depreciate their stepped-up basis against rental income. Congress en-

acted Section 117(m) to make the shareholders' gain on liquidation ordinary income rather than capital gain. If an individual had made a movie with the intention of renting it, he would have capital gain on a subsequent sale since it would not have been held primarily for sale to customers in the ordinary course of his trade or business." (R. 36-37.) This reasoning leads on to the following conclusion: "Therefore, the collapsible corporation provision was intended to apply to some cases when the asset if sold by the taxpayer would have produced capital gain. However, if the *Ivey* decision is applied where a movie is made by a corporation which is then dissolved, the collapsible corporation provision will have no application to the basic fact situations which prompted its enactment." (R. 37.)

Having reasoned its way to a conclusion that it finds disturbing, the Court of Appeals then proceeds to build upon it. "Of course, this difficulty," it states, "could be remedied by interpreting the *Ivey* decision as applicable only to sales of stock and not to liquidations. Thus, when the stock of a corporation is sold, it would not be collapsible if the underlying assets would have produced capital gain had no corporation been used, but when a corporation is liquidated, it would be collapsible regardless of whether the underlying assets would have produced capital gain had no corporation been formed. However, since Congress chose to use a single statute to deal with both types of cases, it seems unwise for the courts to create the additional complexities inherent in such a two-fold interpretation." The court then vaguely intimates that the alleged "complexities" would be too difficult for the courts to handle. (R. 37.)[14]

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[14] At this point the opinion refers to an amendment enacted in 1958. This amendment is discussed at pp. 81-94, *infra*.

We respectfully submit that this entire reasoning derives from a plain misunderstanding of the statute, as well as our own position. The difficulties which trouble the court are entirely of its own making.

We are not remotely contending that "the sole purpose of the collapsible corporation provision was to deal with those cases where the shareholder would have had ordinary income if he had sold the assets himself." Nor are we unaware that section 117(m) was meant to encompass liquidations of corporations as well as sales of stock. Our summary of the extensive legislative history fully discloses that fact with the required detail. The basic vice of the court's reasoning is a loose assumption in which it engages on its own. The court erroneously supposes that the enactment of section 117(m) had two separate purposes. The first alleged purpose was to deal with sales of stock. The second alleged purpose was to deal with liquidations of corporations. On the basis of this premise the court then makes a broad leap to its conclusion. That conclusion, briefly stated, is this: if the statute applies to a profit realized in the case of a liquidation, then it necessarily applies to a profit realized in the case of a sale of stock. In other words, it is wholly immaterial that the profits from the sale and from the liquidation are distinctly unlike. And, as we further understand the court's opinion, it makes no difference that the resulting tax in the case of the sale is "unwarranted," for this is the conclusion that Congress allegedly ordained.

In our view Congress is entitled to much more respect for its efforts to devise a fair tax system. The enactment of section 117(m) was designed to serve one over-all purpose—to prevent the conversion of "ordinary business income into the more favorably treated

capital gains." See p. 29, *supra*. Such conversions were effected in different ways, depending on the property involved. For example, in the motion picture industry, where films are rented, the procedure was to liquidate the corporation, report a capital gain based on the fair market value of the film, rent the film as the corporation would have done, and amortize the value of the film against the receipts from the film. See pp. 29, 34, *supra*. The stockholders were able to have their cake, and eat it, too. They continued to own the film, and their rental income was taxed as capital gain. On the other hand, in the building business the situation was different. As the hearings and committee reports indicate, the Treasury and Congress were concerned with contractors who "construct buildings for sale." See pp. 30-31, 33-35, *supra*. If a contractor built and sold properties as an individual, the profits were ordinary income. If he did so through a corporation, the profits were also ordinary income. The artful use of a corporation enabled contractors to convert these profits into capital gain in either of two ways. One procedure was to liquidate the corporation, report a capital gain based on the fair market value of the houses, sell the houses as the corporation could have done, and apply that value against the sales price. In this way normal business income was transmuted into capital gain to the extent of the reported value of the houses. The other procedure, producing the same conversion, was to sell the stock in the corporation at a price equal to the same value.

In some cases, then, the ordinary income so converted was rent from property which the stockholders continued to own and lease. In other cases the ordinary income so converted was profit from the sale of prop-

erty to customers in the regular course of business. In order to reach every kind of converted ordinary income, the draftsmen had to cover both liquidations of corporations and sales of stock—which is precisely what they did. The one and only purpose was to prevent conversions in each and every case, regardless of which method was used. But it does not in the least follow, as the court below infers, that because the statute may apply to a liquidation relating to property held for rental, it *ipso facto* applies to a sale of stock. "In law also the right answer usually depends on putting the right question." *Rogers' Estate* v. *Helvering*, 320 U.S. 410, 413 (1943). The relevant inquiry is not whether a sale should be treated like a liquidation, but whether the stockholder is enabled to realize the gain proscribed by the statute—the gain that Congress intended to tax as disguised ordinary income. If for some reason any doubts remain, they should be completely removed by the committee reports. As the reports expressly explain, section 117(m) includes sales of stock as well as liquidations in order to reach those cases where the use of a corporation raises "the same tax questions" through a sale as through a liquidation. See p. 35, *supra*. And such "same tax questions" are the attempted conversion of ordinary income into capital gain. A sale of stock which produces the same capital gain as if the stockholders had individually owned and sold the property does not remotely involve "the same tax questions" as a conversion of ordinary income through a liquidation.

Professor Surrey, now Assistant Secretary of the Treasury, has well summarized the precise purpose and reach of section 117(m) as it affects sales of stock and liquidations in varying contexts. Collapsible corpora-

tions, he writes, are "corporations with assets whose sale by the corporation in the normal course of events would produce appreciable amounts of ordinary income. However, instead of sale by the corporation, the shareholders either sell the corporate stock or liquidate the corporation, *i.e.*, 'collapse' the corporation, and then sell the assets, either route producing only a capital gain." Professor Surrey then considers other situations where a corporation would realize ordinary income "in the normal course of events" through a lease or license rather than a sale of assets. The situation, he states, "may involve a corporation which would under normal operation receive ordinary income from the license or rental of its assets, but which instead liquidates at a capital gain to the shareholders, thus providing a high basis for the shareholders to amortize against their receipt of the license or rental income. Without some special provision to deal with these situations, the ordinary income inherent in many business situations would be converted into capital gain." Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Study on Legislative Revision*, 14 Tax L. Rev. 1, 15 (1958).

As this analysis indicates, the design of the statute is to reach gains which "in the normal course of events" or "under normal operation" would be realized as ordinary income. The sole purpose is simply to tax "the ordinary income" so converted, whether the conversion be effected through a sale of stock or a liquidation of the corporation. Congress did not, as the Court of Appeals holds, choose "to use a single statute to deal with" two "types of cases"—sales of stock and liquidations. See p. 70, *supra*. Congress

wrote a single statute to deal with a single case—the realization of ordinary income as a capital gain. And so there is no problem, as the Court of Appeals infers, of engaging in "a two-fold interpretation." *Ibid.* The one question in every case is whether the disposition of the stock produces the gain contemplated by the statute—an attempted conversion of ordinary income. That gain is not produced where the shareholder's profit "would be taxable as a capital gain had he realized it directly rather than through the corporate vehicle." See pp. 58-59, *supra*. The application of the statute turns on the nature or content of the profit realized, just as it does when section 117(a) is involved. See pp. 23, 51-52, *supra*. A determination under section 117(a) "rests primarily on the character of the gain and the relation of the nature of the gain to the nature of the taxpayer's business." The same principle necessarily controls under subsection (m), which simply supplements subsection (a). See pp. 26, 52, *supra*.

At this point it seems appropriate to restate our position on the issue before the Court. Section 117(m) provides that a corporation is collapsible if it is formed or used principally for the construction of property with a view to (1) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise) before the corporation itself realizes a substantial part of the net income to be derived from the property, *and* (2) the realization by the shareholders of gain attributable to the property. It is our position that the gain attributable to the property, which must motivate its construction, means profit which would normally be realized as ordinary income by the corporation, or by the shareholders if they individually owned and operated the property. In some cases the shareholders

may be able to realize this gain through a liquidation. In others they may be able to do so through a sale of stock. But whether a corporation is liquidated or its stock is sold, a corporation is not collapsible within section 117(m) unless, in addition, the shareholders realize the precise gain contemplated by Congress. The fact that a liquidation may produce such a gain is no reason for penalizing a sale which, by the court's own admission, has not produced any such gain. We do not see how this application of the statute, in strict accordance with its legislative history, creates "additional complexities," to which the court mysteriously alludes.

The court's construction comes down to this. It holds that a gain realized on a sale of stock must be treated as ordinary income, even though the gain would clearly be a capital gain if realized on a sale by the corporation itself, or by the shareholders as individual owners of the property. And it does so on the ground that while the sale of stock does not effect a conversion of ordinary income, a liquidation of the corporation might produce such a result. Therefore, a sale should be treated like a liquidation, despite the fact that the results are entirely different. This is, indeed, strange reasoning in the name of a statute designed solely to proscribe tax avoidance. To borrow the language of the Court of Appeals, only under our construction of the statute is it appropriately applied "to the basic fact situations which prompted its enactment." See p. 70, *supra*.

We have yet to consider one other point which the Court of Appeals makes in support of its reasoning. The point relates to the *Ivey* decision, as it applies to sales of stock. Under that decision, the court states, a distinction is drawn between gain attributable to

property held six months or less, and gain attributable to property held over six months. "Thus, any assets which the corporation has acquired within six months and which would be capital assets in the shareholders' hands will produce short-term capital gain while those held longer than six months will produce long-term capital gain." The court then observes: "Regardless of the theoretical wisdom of this approach, it has no basis in the collapsible corporation provision which Congress has enacted. 'One of the clear policy decisions embodied in Section 117(m) and its successor is the treatment of all or none of the gain as long-term capital gain, *i.e.*, the refusal to split the gain between long-term capital gain and ordinary income.'" (R. 37-38.)

The present case, unlike the *Ivey* case, does not involve any such problem of short-term and long-term assets. In any event, here again the Court of Appeals was overly disturbed by a nonexistent problem. The gain reached by the statute is a profit which constitutes a conversion of what would have been ordinary income if realized in the normal course of business. Therefore, to the extent that a profit is a conversion of a short-term gain, it is properly taxable under section 117(m)—assuming, as the statute further requires, that the property was constructed with a view to making a quick sale of stock and realizing such a profit.

The opinion below does not add much by emphasizing that under section 117(m) "all or none of the gain" is treated "as long-term capital gain." There is more to the statute than the opinion indicates. We are referring to the so-called 70-30 rule contained in paragraph (3)(B). This paragraph provides that even if a corporation is collapsible, the statute does not apply

unless over 70 percent of the stockholder's recognized gain is gain attributable to the constructed property. As we have argued, the gain attributable to the constructed property is the gain which constitutes converted ordinary income. Hence, if over 70 percent of the recognized gain is converted ordinary income, the entire amount is taxable as ordinary income—including the portion which otherwise qualifies as a bona fide capital gain. On the other hand, if 70 percent or less is gain which is converted ordinary income, section 117(m) does not apply. The statute, then, specifically contemplates that the amount realized on a sale of stock may consist of both "collapsible" profit and "non-collapsible" profit. In such situations it further contemplates that the Treasury and the courts will determine the precise percentages allocable to each. The case put by the court falls within paragraph (3)(B), just like any other case where an allocation is necessary.

The last paragraph in the opinion below is a revealing commentary on its reasoning. "Although the courts," the opinion states, "must often interpret sections of the Internal Revenue Code in light of their purposes in order to carry out Congressional intent . . . , when this would require the courts to extensively rewrite clear statutory language, the task of revision should be left to Congress. . . ." (R. 38-39.) In the end, then, the Court of Appeals feels obliged once more to fall back upon its "literal" reading of the statute. And this renewed retreat to the "letter" is accompanied by a disclosure which corroborates our analysis of the opinion. Despite its varied efforts to justify its decision, the court rather frankly concedes that it has not interpreted the words of section 117(m) "in light

of their purposes in order to carry out Congressional intent." No matter how circumspectly phrased, this confession speaks for itself. The decision admittedly contravenes the policy and design of the statute. The court seeks to mitigate its unpleasant confession by adding that it cannot rewrite statutes. But there is nothing to rewrite here, just as there was nothing to rewrite in the two decisions which the court cites and tries to distinguish—*Corn Products Co.* v. *Commissioner, supra*; and *Gregory* v. *Helvering, supra*. The only judicial task here is to apply the relevant words of the statute as Congress and also the Treasury meant them to be applied. That task merely requires subsection (m) of section 117 to be construed as subsection (a) is construed—with the same perceptive respect and concern for the purposes of Congress. See pp. 52, 75, *supra*. In failing to discharge that obligation, the Court of Appeals has done the very thing it purports to avoid. It has revised the statute, so that it does precisely the opposite of what Congress so plainly contemplated. See pp. 39-40, 48, 56-59, *supra*.

The opinion below attempts to justify this mutilation of legislative policy by citing this Court's recent decision in *Hanover Bank* v. *Commissioner*, 369 U.S. 672 (1962). That decision, we gather, is supposed to illustrate that a correct construction of statutes may contravene "their purposes" as well as "Congressional intent." The Court of Appeals has clearly misread the *Hanover Bank* decision—which, it so happens, reversed the same Court of Appeals. 289 F. 2d 69 (2d Cir. 1961). The question in that case was whether bond premium was amortizable on the basis of a special call price or a higher general call price. This Court held that the taxpayer had properly computed amorti-

zation by reference to the special call price. It did so after closely examining the legislative history of the statute involved. In sharp contrast to the opinion below, the Court did not resort to a "literal" construction without regard for the purpose of Congress. As the Court summarized its painstaking analysis, "We are bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history. In neither do we find support for the Government's interpretation." 369 U.S. at 682. In view of the legislative history, the Court pointedly concluded that "the Government now urges this Court to do what the legislative branch of the Government failed or elected not to do." *Id.* at 688.

The opinion below is a far cry from the *Hanover Bank* decision. Here the Court of Appeals refused to be bound by the meaning of the words used by Congress, taken in light of the pertinent legislative history.[15] However, the two cases have at least one thing in common. In both the Government has asked this Court to do what neither Congress nor the Treasury set out to do. *Cf. Hanover Bank* v. *Commissioner, supra,* at 688.

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[15] More recently another panel of the Second Circuit has read the *Hanover Bank* decision more accurately. See *J. C. Penney Co.* v. *Commissioner*, 63-1 U.S.T.C. ¶ 9129 (1962). There the Government argued, in the light of the legislative history, that the statute should not be construed so as to confer a "bonanza" on the taxpayer. Here the Government is arguing, in disregard of the legislative history, that the statute should be construed so as to confer a bonanza on itself. The Government is rarely troubled by such incongruities.

V. The Decision Below Cannot Be Justified By a Later Law. Enacted in 1958. Which Amended the Internal Revenue Code of 1954

We now reach the closing portion of the Court of Appeals' opinion. As a final ground for its conclusion, the court cites a statute enacted eight years after the taxable year involved here. This later statute is section 341(e) of the 1954 Code, an amendment added by section 20 of the Technical Changes Act of 1958, 72 Stat. 1615. The amendment induces the court to reason as follows.

The court states that "regardless of how compatible with the statute" our construction may have been before 1958, "the addition of § 341(e) in that year" makes the construction "anomalous." While this amendment of 1958 "did not completely eliminate the conversion of capital gain into ordinary income by the collapsible corporation provision, it was designed to narrow the imposition of ordinary income treatment in an *Ivey* type of case where the shareholder would have recognized capital gain had he constructed and sold the asset without the use of a corporation." The court then reasons, "if *Ivey* is correct, either § 341(e) is unnecessary or, if it is regarded as overruling *Ivey*, it expands rather than contracts the application of the collapsible corporation provision, clearly the contrary of what Congress intended." (R. 38.)

The Court of Appeals has seriously misconstrued the later action of Congress—even if we erroneously assume, for the moment, that it is otherwise relevant here. If the 1958 amendment proves anything, it clearly confirms that the Treasury has harshly misapplied section 117(m). In this case it is particularly true that "a page of history is worth a volume of logic." *New York Trust Co.* v. *Eisner*, 256 U.S. 345, 349 (1921).

Section 341 of the 1954 Code succeeded section 117 (m) of the 1939 Code. Subsection (e), added in 1958, provides that gain realized on a sale of stock is taxable as capital gain if the so-called "ordinary income" assets of the corporation at the time of sale do not exceed 15 percent of its net worth. Such assets, generally speaking, are properties which would result in ordinary income if sold by the corporation. This provision is elaborated in an extremely intricate statute. It applies only to years beginning after December 31, 1957, but only with respect to sales and liquidations after its date of enactment—September 2, 1958.

The amendment originated in the Senate Finance Committee, which prepared an extensive report on it. Sen. Rep. No. 1983, 85th Cong., 2d Sess. 1, 3, 31, 142 (1958). The Committee stated that the "more significant changes in the bill" were "those concerned with 'unintended benefits' and 'unintended hardships.'" *Id.* at 1. The amendment of section 341 was included among the changes dealing with "unintended hardships" to taxpayers. *Id.* at 3.

The Committee summarized the relevant hardships as follows (*id.* at 31-32):

> "Section 341 of the 1954 Code relates to collapsible corporations. The purpose of this provision, enacted originally in 1950, is to prevent income which would otherwise be taxed at ordinary income tax-rates from being converted into income taxable at capital-gain rates merely by use of the corporate entity. For example, the collapsible-corporation provisions are intended to prevent a taxpayer from transferring inventory items owned by him to a corporation and then selling the stock of the corporation at capital-gain rates to avoid the ordinary income tax which he would have been required to pay if he had sold the inventory directly.

"The collapsible-corporation provisions of present law, however, both by their terms and as interpreted, are so broad that in a number of situations they may have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordin ry income. The applicability of the provisions of present law, moreover, depend upon the subjective intent of the parties, a matter which is obviously difficult to determine. Furthermore, if the collapsible-corporation provisions do apply, the entire gain of the shareholder is taxed at ordinary income rates, notwithstanding the fact that had the shareholder not employed the corporate entity a large part of his gain might have been taxed at capital-gain rates. For these reasons, the collapsible-corporation provisions [of] present law frequently impede or prevent legitimate business transactions and in some cases even result in the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business."

The Committee next explained why the existing limitations on the statute, "as interpreted," did not eliminate "the problems" with which it was concerned (*id.* at 32):

"For example, in the case of corporations engaged in the development of natural resources, which have continued development activity, the shareholders of such corporations can never be certain that their stock interests in such corporations will not be regarded as stock interests in a collapsible corporation, notwithstanding the fact that their corporations have little or no inventories and that the properties of such corporations (if sold by the corporation or by the shareholders)

would be regarded as properties the sale of which would result in capital gain. *Similarly, real-estate corporations established by investors (as distinguished from dealers) holding rental property for investment only may be regarded as collapsible corporations under present law.*

"... Your committee believes that this amendment is desirable in order to avoid determination of subjective intent in the situations described in this amendment and also to avoid the possibility in this area of the conversion of capital gain income into ordinary income. *Furthermore, it is believed that this amendment will have the effect of removing some of the impediments that presently exist in the case of legitimate business tranactions without permitting the tax avoidance which the collapsible corporation provisions are intended to prevent.*" (Italics supplied.)

The Committee then analyzed the various provisions of the amendment. These were explained as precautionary rules which would prevent stockholders from changing "the character of their income merely by employing the corporate form of doing business. Thus, under these rules, opportunities will not be created for the conversion of ordinary income into capital gain." *Id.* at 33.

Finally, the Committee specifically considered the relation of the amendment to cases not falling within its terms. The amendment, the Committee stated, is "not for the purpose of causing any corporation to be regarded as a collapsible corporation. Your Committee recognizes that there may be legitimate corporate enterprises that will be unable to meet the terms of the limited statutory exceptions" in the amendment.

"Your Committee does not believe that any inference should be drawn from the failure of any corporation, or the failure of any corporation with respect to any of its shareholders, to meet the requirements for any or all of the new statutory exceptions to the application of the collapsible corporation provisions. Accordingly, it is expressly provided that in determining whether any corporation is a collapsible corporation within the meaning of section 341 (b) of the 1954 Code, the fact that such corporation or such corporation with respect to any of its shareholders, does not meet the requirements of any of the new rules shall not be taken into account, and such determination shall be made as if such rules had not been enacted." "Thus, the new subsection merely provides rules under which a corporation may avoid being classified as collapsible; *it will never result in causing a corporation to be classified as collapsible.*" *Id.* at 34, 142. (Italics supplied.) See also Conf. Rep. No. 2632, 85th Cong., 2d Sess. 22-23 (1958).

To complete the picture, we quote the further statement made by Chairman Mills, of the Ways and Means Committee, on the floor of the House (104 Cong. Rec. 17821 (1958)):

> ". . . the purpose of the collapsible corporation rule now contained in section 341 is to prevent what would otherwise be ordinary income from being converted into capital gains. However, because of the breadth of the terms of the section it is being administered and interpreted ~~so as~~ to have the consequence of converting what would otherwise be capital gains into ordinary income. The Senate amendment will correct this in cases falling under its terms."

This later chapter of legislative history does not in any way sustain the conclusion below. On the contrary, it reveals an acute discontent with the Treasury's administration of the statute and further confirms our own interpretation. First, it reaffirms that the purpose of the statute on collapsible corporations is to prevent the conversion of ordinary income into capital gain through the use of a corporate entity. Second, it deplores the fact that as "administered and interpreted," the terms of the statute "may have exactly the opposite effect from that intended—instead of preventing the conversion of ordinary income into capital gain, they may instead convert what would otherwise be capital gain into ordinary income." The Finance Committee severely criticizes "the imposition of ordinary income taxes which would not be imposed if the shareholders of such corporations had not employed the corporate method of doing business." The Committee particularly indicates that real estate corporations, "holding rental property for investment only," may be treated as collapsible corporations, though the resulting gain would be a capital gain if the property were sold by the corporation or by the shareholders. This substantial disparity in treatment is described as an "unintended hardship." Third, the Committee expressly states that no adverse inference is to be drawn against any corporation because it fails to fall within the specific terms of the amendment. In such cases the status of a corporation is to be determined as if the amendment "had not been enacted."

The essence of the matter seems clear. In adding a limited amendment for the future, Congress did not approve the Commissioner's construction for the past. Even if such an amendment might conceivably gen-

erate retroactive implications in other circumstances, no such implication is discernible here. The Finance Committee, as well as the amendment itself, flatly forbid any to be drawn. See p. 85, *supra.* The specific provision to this effect is a special paragraph (11), entitled "Corporations and Shareholders Not Meeting Requirements." This paragraph states that in "determining whether or not any corporation is a collapsible corporation" within the definitional provisions, "the fact that such corporation, or such corporation with respect to any of its shareholders, does not meet the requirements" of subsection (e) "shall not be taken into account, and such determination, in the case of a corporation which does not meet such requirements, shall be made as if this subsection had not been enacted." Int. Rev. Code of 1954, § 341(e)(11). The Court of Appeals' attempted reliance on the 1958 amendment directly contravenes the amendment itself and its authoritative committee report.

The Government's reasoning in regard to the 1958 amendment is quite strange and very simple. The Government generously assumes, in its own behalf, that any legislative change prompted by dissatisfaction with its prior interpretation of the statute is cogent proof that its prior interpretation was correct. Needless to say, the Court has refused to be a party to such imaginative rationalizations.

In *Haggar Co. v. Helvering, supra*, the Court dealt with a similar effort to derive a Congressional blessing from a later amendment. The amendment was accompanied by a report which described the prior administrative practice as "unduly restrictive." 308 U.S. at 399. In accordance with his present mode of

reasoning, the Commissioner argued that Congress, through the amendment, had "attributed to the earlier statute the same meaning as that ascribed to it by the administrative construction." By approving an amendment "which would preclude such a construction in the future"—the argument ran—Congress had "also declared that the departmental construction was that intended by the earlier Congress which enacted the statute." *Id.* at 398. The Court, in an opinion by Mr. Justice Stone, quickly disposed of this ingenious contention. "In the face of the legislative expression of dissatisfaction with the earlier statute as construed, Congressional purpose to declare that such was the intended meaning is not to be inferred merely from the fact that the amendment providing for the future said nothing as to the past. If we are to draw inferences it would seem as probable that Congress was content to leave the problems of the past to be solved by the courts where they were then pending, rather than to preclude their solution there." *Id.* at 400.

Mr. Justice Stone's analysis is even more applicable here. The Finance Committee not only disapproved the administrative interpretation as contrary to Congress' purpose, but it declared in so many words, both in the amendment and the report, that no adverse inferences were to be drawn against taxpayers. Even in the future any case that does not fall within the amendment is to be decided as if it had never been enacted. See pp. 85, 87, *supra*.

Indeed, the Commissioner's effort to infer Congressional approval through the amendment borders on the bizarre. The first decision by a trial court, sanctioning the Commissioner's construction of section 117(m), was rendered on April 30, 1957. *Raymond G. Burge*,

28 T.C. 246. See also *Edward Weil*, 28 T.C. 809, and *Arthur Glickman*, 16 T.C.M. 532, both decided on June 28, 1957. The first appellate decision to the same effect was rendered on March 3, 1958. *Burge* v. *Commissioner*, 253 F. 2d 765 (4th Cir.). See also *Weil* v. *Commissioner*, 252 F. 2d 805 (2d Cir.); and *Glickman* v. *Commissioner*, 256 F. 2d 108 (2d Cir.), decided, respectively, on March 6 and June 5, 1958. On July 28, 1958, the Finance Committee filed its report, including the amendment on collapsible corporations. As this rapid sequence graphically shows, the Finance Committee acted with unusual dispatch after the initial appellate decisions applying section 117(m) to the sale of rental property held for investment. To find Congressional approval of the past here is simply to ignore what Congress has said and done. The very purpose of the 1958 amendment was to prevent the construction which the Commissioner is now zealously pursuing. Cf. *Helvering* v. *New York Trust Co.*, *supra*, at 468-469; *United States* v. *Laws*, 163 U.S. 258, 265-266 (1896); *Levindale Lead & Zinc Mining Co.* v. *Coleman*, 241 U.S. 432, 439 (1916). The amendment did not declare a new policy. It was "a more explicit expression of the purpose" of the original statute, compelled by the Commissioner's application of that statute. Cf. *Jordan* v. *Roche*, 228 U.S. 436, 445 (1913); *Haggar Co.* v. *Helvering*, *supra*, at 400. The Commissioner is trying very hard to make a virtue of his own error. Through some peculiar process of reasoning he has concluded that his construction must have been correct because Congress promptly disapproved it.

Even within the terms of its own reasoning, the opinion below leaves much to be desired. The Court of Appeals states that "regardless of how compatible with

the statute the *Ivey* interpretation may have been previous to 1958," the enactment of section 341(e) in that year made the interpretation "anomalous." See p. 81, *supra*. But if section 341(e) created the anomaly, then there was no anomaly until 1958—or eight years after the taxable year involved here. The present case turns on the statute as it stood in 1950, not on the statute as it may have been affected long afterward by an amendment. In fact, the 1958 amendment itself states that it applies only prospectively. Moreover, the amendment was an addition to section 341 of the 1954 Code—not section 117(m) of the 1939 Code, which is the controlling statute here. Section 341 was enacted as part of a comprehensive new Code. Even if the court's reasoning, on some theory, were possibly relevant as a retroactive gloss on section 341, it cannot in any way affect section 117(m). In 1950, when section 117(m) was enacted, Congress was necessarily unaware of the construction later attributed to it by the Commissioner. The question here is what the legislative draftsmen intended in 1950—not in 1954. Each statute in each Code must be interpreted in the light of its own legislative history. *Commissioner* v. *Bilder*, *supra*, at 504-505. The Treasury itself has succinctly stated the answer. The legislative history of section 117(m) "makes it clear that the objective was to prevent the successful use of a device for converting ordinary income into long-term capital gain through the medium of a corporation." Rev. Rul. 56-60, *supra*, at 175-176.

Finally, quite apart from the special considerations involved here, the 1958 amendment and the related committee report cannot cast any retroactive implica-

tions in the Commissioner's favor. Later legislative history—whether it be reflected by committee reports or other materials—is not relevant evidence of what a prior statute means. See *Penn. Mutual Co.* v. *Lederer,* 252 U.S. 523, 538 (1920); *Okla. Press Pub. Co.* v. *Walling,* 327 U.S. 186, 197, n. 20 (1946); *Fogarty* v. *United States,* 340 U.S. 8, 13-14 (1950); *United States* v. *Turley,* 352 U.S. 407, 415, n. 14 (1957). The backward use of later committee reports "would amount to retroactive amendment by committee report, a step in construction by reference to 'prospective legislative history' not heretofore taken." *Okla. Press Pub. Co.* v. *Walling, supra,* at 197, n. 20. As the Chief Justice recently wrote of another effort to obtain "succor" from later legislative activity, "statutes are construed by the courts with reference to the circumstances existing at the time of passage." How a later Congress may have understood an earlier statute "is not of weight" in construing the earlier one. *United States* v. *Wise,* 370 U.S. 405, 411, 414 (1962). See also *United States* v. *Price,* 361 U.S. 304, 313 (1960). And only this Term the Court stated, without deeming it necessary to cite any supporting decisions, that "subsequent legislative materials are neither appropriate nor relevant guides to interpretation of prior enactments." *Federal Trade Commission* v. *Sun Oil Company,* No. 56, January 14, 1963. The obligations of a taxpayer for a particular year stem from the statutes passed by Congress for that year—not from *ex post facto* observations, through a report or otherwise, made on some later occasion. Nothing that was said in 1958 can change the legislative purpose and policy expressed in 1950. See *Penn. Mutual Co.* v. *Lederer, supra,* at 538; *United States* v. *United Mine Workers,*

330 U.S. 258, 282 (1947); *Fogarty* v. *United States*, *supra*, at 14.[16]

Insofar as the amendment itself is concerned, the Commissioner's position is no better—even if the 1958 amendment, contrary to its own terms, is regarded as some attempted gloss upon the statute enacted in 1950.[17] A later amendment cannot give a statute enacted earlier "a different meaning from what it then acquired." *Gemsco, Inc.* v. *Walling*, 324 U.S. 244, 265 (1945), involving an amendment enacted two years later. Congress' later "interpretation as such is immaterial. It is as likely to be wrong as anyone else, and in the end the courts must decide." *Fire Companies Bldg. Corp.* v. *Commissioner*, 54 F. 2d 488, 489 (2d Cir. 1931). See further *Gilbert* v. *Thierry*, 58 F. Supp. 235, 242 (D. Mass. 1944), *aff'd*, 147 F. 2d 603 (1st Cir. 1945), stating that "the use of an amendatory statute to interpret the original statute is contra-canonical." At most a later statute can only indicate what a later Congress may have thought. It sheds no light on what an earlier Congress contemplated or intended. See *Higgins* v. *Smith*, 308 U.S. 473, 479-480 (1940); *Rainwater* v. *United States*, 356 U.S. 590, 593 (1958). *Cf. Haggar Co.* v. *Helvering*, *supra*, at 400.

Under our system of law it cannot be otherwise. "The interpretation of the meaning of statutes, as ap-

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[16] Cf. *Commissioner* v. *Acker*, 361 U.S. 87, 92-93 (1959), which dealt with committee reports accompanying a prior act. There the Court declared invalid a regulation embodying a statement contained in reports relating to "the forerunner of the section" involved, "and not to that section itself" enacted eight months later.

[17] However, as we have noted, the 1958 statute did not amend the statute enacted in 1950. See p. 90, *supra*.

plied to justiciable controversies, is exclusively a judicial function." *United States* v. *American Trucking Assns., supra*, at 544. Well over 150 years ago an attorney argued before this Court that a later act "could not alter the past law, and make that to have been law which was not law at the time. To declare what the law is, or has been, is a judicial power; to declare what the law shall be, is legislative. One of the fundamental principles of all our governments is, that the legislative power shall be separated from the judicial." The Court considered this statement of principle so clear and settled, that it "stopped the counsel, observing that it was unnecessary to argue that point." *Ogden* v. *Blackledge*, 2 Cranch 272, 277 (1804). See *Town of Kashkonong* v. *Burton*, 104 U.S. 668, 678-679 (1882); *United States* v. *Wise, supra*, at 414. "The utmost effect to be given to a subsequent legislative declaration" is "to regard it as an alteration of the existing law in its application to future transactions." *Town of Kashkonong* v. *Burton, supra*, at 679. As Chief Justice Marshall declared, "a legislative act founded on a mistaken opinion of what was law, does not change the actual state of the law as to pre-existing cases." *Talbot* v. *Seeman*, 1 Cranch 1, 35 (1801). In his pursuit of the present deficiencies the Commissioner is blissfully unaware of what was already well settled in the early years of this Court.

The crux of the Court of Appeals' position may be simply stated. The court has held that Congress' action, taken in 1958, has retroactively affected the meaning of section 117(m), enacted in 1950. If this conclusion is correct, despite all our arguments to the contrary, it necessarily raises grave constitutional issues. First, the conclusion assumes that Congress

may constitutionally exercise the power of construing statutes—a power which "is exclusively a judicial function." Second, the conclusion further assumes that Congress may retroactively increase tax liabilities, after the lapse of eight years, without violating the due process clause of the Fifth Amendment. *Cf. Haggar Co. v. Helvering, supra,* at 400; *Claridge Apartments Co. v. Commissioner,* 323 U.S. 141, 164-165 (1944). Apparently the Commissioner is untroubled by such questions.

VI. The Government's Application of Section 117(m) Violates the Standards of Responsible Tax Administration

We have completed our analysis of the Commissioner's position and the opinion below. However, our discussion would be incomplete if we failed to consider a more basic issue which underlies the question of construction before the Court. That issues radiates well beyond the confines of this case. It goes to the very essence of tax administration in our democratic society.

As the Government itself has repeatedly stated, the purpose of section 117(m) was to prevent taxpayers from obtaining a special tax benefit through incorporating an enterprise. That benefit consists of realizing as a capital gain what would have been ordinary income in the normal course of business if the stockholders had owned the property directly or the corporation itself had realized the income. Here, concededly, if the stockholders themselves had owned and sold the development, the profit on the sale would have been a capital gain. Again, if the corporations had sold the development, the profit would have also been a capital gain. See pp. 38-39, *supra.* Nevertheless the Government is assiduously contending that the

same profit realized through a sale of stock is ordinary income. A statute solely designed to prevent a conversion of ordinary income into capital gain is boldly applied so as to produce a conversion of capital gain into ordinary income. The Government, in short, has turned the statute upside down. In the process of supposedly construing the statute, it has emerged with a travesty of the statute. Good sense is turned into nonsense—under the alleged authority of those who made good sense. The sum and substance of the matter is that taxpayers are punished for the apparent misdeed of having owned property through a corporation rather than as individuals. See pp. 56-59, *supra*. Section 117(m) was proposed and enacted in order to correct gross "inequities". See p. 27, *supra*. As the Government reads and applies the statute, Congress decided to replace one inequity with another.

This kind of administration brings us to the more basic issue which this case unfortunately raises. May the Treasury disregard legislative hearings and committee reports which clearly disclose the intended meaning and scope of tax legislation entrusted to its fair administration? May it close its eyes and ears to the plainly expressed policy of a statute, and proceed to improvise a policy of its own by reading the words to suit itself? These questions involve no less than the integrity of the administrative process in our tax system. It is often said that taxpayers have an ethical responsibility to the Treasury. But as this case illustrates, it is not always remembered that the Treasury has an ethical responsibility to taxpayers—and to Congress, too. A department of Government which constantly exhorts taxpayers to be guided by standards of moral excellence should gladly serve as a model in applying those same canons of behavior.

Under our Constitution the taxing power is entrusted solely to Congress. Tax policy is made by Congress in the continuous give-and-take of the democratic process. This scheme of things reflects a painful lesson of history—that of all powers exercisable by government, the power to tax is probably the most susceptible to administrative abuse. The only function of the Treasury is to consummate the purposes of Congress. The Treasury "can add nothing to income as defined by Congress," though it may firmly feel that the definition could be improved. *M. E. Blatt Co.* v. *United States*, 305 U.S. 267, 279 (1938). There is no taxation without legislation. Any tax "asserted by the Commissioner" must be "authorized by Congress." *Helvering* v. *Griffiths*, 318 U.S. 371, 394 (1943). We have no desire to criticize the energetic enforcement of our tax laws. But enforcement goes well beyond its allotted province when it ignores the unmistakable purposes of Congress. At that point, it is simply an obvious effort to collect as much tax as possible, without due respect for the wishes of Congress.

This case unhappily reveals that kind of administration. For we have here a steadfast refusal to pay attention to an unmistakable legislative purpose—a purpose to which the Treasury itself significantly contributed. First the President carefully indicated the scope of the requested statute. Next the Secretary of the Treasury elaborated upon the proposal before the Ways and Means Committee. Then the General Counsel of the Treasury analyzed the proposal further in response to searching questions. The hearings were followed by House and Senate committee reports. These reports clearly summarized anew the precise purpose

and reach of the statute. And then the same summary was largely repeated in a separate report prepared by the Staff of the Joint Committee on Internal Revenue Taxation. Moreover, the Staff of the Joint Committee helped prepare the Memorandum which the Treasury submitted to the Ways and Means Committee. See pp. 27-35, *supra*. If there was ever a thorough legislative history articulating Congress' policy, this is it. Yet the Treasury has gone ahead as if there were no such history and policy. It has refused to see what anyone can see who would apply the statute as Congress intended. It asks this Court to construe the statute in blinkers.

When the statute was enacted in 1950, no one in Congress or the Treasury even slightly suggested any such liability as the Commissioner is now asserting. If a taxpayer and his attorney studied the hearings, they were informed that the gain to be taxed under the statute was ordinary income converted into capital gain. If they consulted the committee reports, their understanding of the statute was fully confirmed. It would, indeed, be a sad reflection on our tax system and the Treasury if taxpayers could not rely on a unanimous expression of views voiced by the President, the Secretary of the Treasury, the General Counsel of the Treasury, the House Ways and Means Committee, the Senate Finance Committee, and the Staff of the Joint Committee on Internal Revenue Taxation. The position now taken by the Government is completely at odds with all these official statements on the statute. "Not one contemporaneous word in or out of Congress discloses the purpose which the Government says we should find that this legislation accomplished." Cf. *Helvering* v. *Griffiths*, *supra*, at 378, 389.

What the Court said in another context is especially pertinent here. "Always a taxpayer is entitled to know with fair certainty the basis of the claim against him." *General Utilities Co. v. Helvering*, 296 U.S. 200, 206 (1935). One of the very reasons for printing committee hearings and reports is to make that necessary knowledge available to him. Today, when tax legislation has become unbelievably complex, they are well-nigh indispensable. Hearings and reports are meant to be read and studied by taxpayers and their advisers. They are a significant means of providing that "fair certainty" to which taxpayers are surely entitled. They illuminate words which would otherwise "dance" before the eyes "in a meaningless procession." Hand, *Thomas Walter Swan*, 57 Yale L. J. 167, 169 (1947). Since hearings and reports are an important source of reasonable expectations, they are also designed to serve as guides to the Treasury and the courts in applying the statutes to which they relate. If the Treasury may quietly disregard relevant hearings and reports, then they are essentially delusive snares laid for taxpayers and their advisers. It would be much better if they were left unpublished.

After the President sent his message, both the Secretary of the Treasury and the General Counsel of the Treasury appeared before the Ways and Means Committee. There they both delineated the special purpose and scope of the legislation. Now the Treasury would prefer to forget the hearings. It would ignore not only the message of the President and the reports of both tax committees, but also its own repeated assurances on the precise reach of the statute—assurances given by the head of the Treasury and another high-ranking official. Again and again, under close ques-

tioning, the Treasury emphasized to Congress that the statute would apply only to corporations used "for the particular purpose of carrying out what we would characterize as tax avoidance"—the avoidance of ordinary tax on the ordinary income from the property—so that "the Treasury may, instead of assessing the capital gains rate, assess the regular income tax rate on the individual." At the same time the Treasury stoutly insisted that it had no desire to affect corporations which operate in normal fashion, paying the ordinary tax on ordinary income. See pp. 31-34, *supra*. It was on the basis of these repeated assurances, given after full consideration of the evils involved, that Congress acted. For that matter, substantial portions of the reports are mere echoes of statements made by the Treasury. Judicial respect for the administrative process presupposes a faithful effort to carry out the policy of Congress. The Treasury here attributes its conclusion to the policy of Congress, while persistently ignoring the legislative data which express that policy. In effect, the Treasury says: We see what you are driving at, but we shall go on as if we do not. Cf. *Johnson* v. *United States*, 163 Fed. 30, 32 (1st Cir. 1908); *United States* v. *Hutcheson*, 312 U.S. 219, 235 (1941).

The Treasury should not be allowed to slight committee reports and its considered assurances before tax committees. Reports and hearings are not to be respected or ignored, depending on whether they sustain the taxpayer or the Treasury. Taxpayers should not be told one thing while legislation is being passed, and then something quite different after it is passed. Taxes are onerous enough without such administrative behavior. In these days of high rates, it is all the more urgent that the Treasury be obliged

to abide by its professions and assurances. The Treasury's action would have been sufficiently grave if it had simply disregarded the legislative history of 1950. But here the Treasury has adopted a flexible approach which is even more revealing. It pays no attention to the legislative history of 1950, and then falls back on what happened eight years later in response to its own misconstruction of the statute. See p. 87, *supra*.

Of course, we have by no means exhausted the Treasury's sustained elasticity. While the Treasury invokes the legislative history of 1958, it completely ignores Congress' explicit admonition that this later history is not to be taken into account. As the Finance Committee stated, the amendment of 1958 "will never result in causing a corporation to be classified as collapsible." See p. 85, *supra*. Again, while the Treasury faithfully abides by the policy of Congress in applying section 117(a), it nicely disregards that policy in applying section 117(m). Different standards of interpretation are used, although both statutes are concerned with the same problem. So-called "literal" meanings generally count only when they happen to favor the Treasury. And all this twisting and turning is methodically attributed to Congress.

If the Treasury has changed its mind since 1950, then the answer is fairly obvious. It should repair to Congress for new legislation, not to this Court. If the Treasury feels that profit which normally constitutes a bona fide capital gain should be taxed as ordinary income merely because an enterprise is incorporated, "such a determination of policy in the administration of the income tax law should be made

by Congress, which maintains a Joint Committee on Internal Revenue Taxation charged with the duty of investigating the operation of the federal revenue laws and recommending such legislation as may be deemed desirable." *United States* v. *Nunnally Investment Co.*, 316 U.S. 258, 264 (1942).

Mr. Justice Douglas' words in *Commissioner* v. *Lester*, 366 U.S. 299, 306-307 (1961), are a fitting observation on the Government's present administrative behavior. "The revenue laws have become so complicated and intricate that I think the Government in moving against the citizen should also turn square corners." "Resort to litigation, rather than to Congress, for a change in the law is too often the temptation of government which has a longer purse and more endurance than any taxpayer." Here, we may appropriately add, the proposed change does not even have the excuse of good sense. President Truman requested the legislation of 1950 in order "to improve the fairness of the tax system." See p. 27, *supra*. The Treasury itself hardly contends that its position contributes much to that objective. Whatever the differences between the Second and Fifth Circuits, they both agree on one thing —that the tax asserted here produces an unreasonable result. The Second Circuit calls it "unwarranted"; the Fifth Circuit, "nonsense".

In describing the responsibilities of tax administration, the Commissioner has stated, "We want to avoid overzealousness or creating an adversary climate. We want fairness and objectivity." Caplin, *Responsibilities of the Tax Adviser—A Perspective*, 40 Taxes 1030, 1031 (1962). These are well-chosen words, with which

no one can quarrel. But they acquire meaning and content only as they are genuinely applied. The Government's administration of section 117(m) is an essay in "overzealousness," rather than the "fairness and objectivity" to which Congress and taxpayers are entitled. At the very least a fair and objective execution of the tax laws requires the Government to keep faith with Congress and those to whom Congress has addressed its laws. We regret to say that in our view the Government's administration of section 117(m) has not approached that standard of performance. We hope that tax administration will never reach the point where "it is not enough to attain to a degree of precision which a person reading in good faith can understand; but it is necessary to attain if possible to a degree of precision which a person reading in bad faith cannot misunderstand." *In re Castioni* [1891], 1 Q.B. 149, 167.

CONCLUSION

For the foregoing reasons the decision of the Court of Appeals should be reversed and the deficiencies should be expunged.

Respectfully submitted,

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APPENDIX

INTERNAL REVENUE CODE OF 1939:

SEC. 117. CAPITAL GAINS AND LOSSES.

(a) [as amended by Sec. 210(a) of the Revenue Act of 1950, 64 Stat. 932] *Definitions.*—

(1) *Capital assets.*—The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business) but does not include—

(A) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(B) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), or real property used in his trade or business;

* * * *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

(b) [as amended by Sec. 150(c) of the Revenue Act of 1942, 56 Stat. 843] *Percentage Taken Into Account.*—In the case of a taxpayer, other than a corporation, only the following percentages of the gain or loss recognized upon the sale or exchange of a capital asset shall be taken into account in computing net capital gain, net capital loss, and net income:

100 per centum if the capital asset has been held for not more than 6 months;

50 per centum if the capital asset has been held for more than six months.

(c) [as amended by Sec. 301(c)(3) of the Revenue Act of 1950, 64 Stat. 953] *Alternative Taxes.*—

* * * *

(2) *Other taxpayers.*—If for any taxable year the net long-term capital gain of any taxpayer (other than a corporation) exceeds the net short-term capital loss, there shall be levied, collected, and paid, in lieu of the tax imposed by sections 11 and 12 . . . a tax determined as follows, if and only if such tax is less than the tax imposed by such sections:

A partial tax shall first be computed upon the net income reduced by the amount of such excess, at the rates and in the manner as if this subsection had not been enacted, and the total tax shall be the partial tax plus 50 per centum of such excess.

* * * *

(j) [as amended by Sec. 210(b) of the Revenue Act of 1950, 64 Stat. 933] *Gains and losses from involuntary conversion and from the sale or exchange of certain property used in the trade or business.*—

(1) *Definition of property used in the trade or business.*—For the purposes of this subsection, the term "property used in the trade or business" means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 23(l), held for more than 6 months, and real property used in the trade or business held for more than 6 months, which is not (A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year, or (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business. . . .

* * * *

(2) *General rule.*—If, during the taxable year, the recognized gains upon sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets

held for more than 6 months into other propery or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months. If such gains do not exceed such losses, such gains and losses shall not be considered as gains and losses from sales or exchanges of capital assets. . . .

* * * * *

(m) [as added by Sec. 212(a) of the Revenue Act of 1950, 64 Stat. 934] *Collapsible Corporations.*—

(1) *Treatment of gain to shareholders.*—Gain from the sale or exchange (whether in liquidation or otherwise) of stock of a collapsible corporation, to the extent that it would be considered (but for the provisions of this subsection) as gain from the sale or exchange of a capital asset held for more than 6 months, shall, except as provided in paragraph (3), be considered as gain from the sale or exchange of property which is not a capital asset.

(2) *Definitions.*—

(A) For the purpose of this subsection, the term "collapsible corporation" means a corporation formed or availed of principally for the manufacture, construction, or production of property, or for the holding of stock in a corporation so formed or availed of, with a view to—

(i) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, prior to the realization by the corporation manufacturing, constructing, or producing the property of a substantial part of the net income to be derived from such property, and

(ii) the realization by such shareholders of gain attributable to such property.

(B) For the purposes of subparagraph (A), a corporation shall be deemed to have manufactured, constructed, or produced the property if—

(i) it engaged in the manufacture, construction, or production of such property to any extent,

(ii) it holds property having a basis determined, in whole or in part, by reference to the cost of such property in the hands of a person who manufactured, constructed, or produced the property, or

(iii) it holds property having a basis determined, in whole or in part, by reference to the cost of property manufactured, constructed, or produced by the corporation.

(3) *Limitations on application of subsection.*—In the case of gain realized by a shareholder upon his stock in a collapsible corporation—

(A) this subsection shall not apply unless, at any time after the commencement of the manufacture, construction, or production of the property, such shareholder (i) owned (or was considered as owning (more than 10 per centum in value of the outstanding stock of the corporation, or (ii) owned stock which was considered as owned at such time by another shareholder who then owned (or was considered as owning) more than 10 per centum in value of the outstanding stock of the corporation;

(B) this subsection shall not apply to the gain recognized during a taxable year unless more than 70 per centum of such gain is attributable to the property so manufactured, constructed, or produced; and

(C) this subsection shall not apply to gain realized after the expiration of three years following the completion of such manufacture, construction, or production.

For purposes of subparagraph (A), the ownership of stock shall be determined in accordance with the rules prescribed by paragraphs (1), (2), (3), (5), and (6) of section 503(a), except that, in addition to the persons prescribed by paragraph (2) of that section, the family of an individual shall include the spouses of that individual's brothers and sis rs (whether by the whole or half blood) and the spouse f that individual's lineal descendants.

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(26 U.S.C. 1952 ed., Sec. 117.)